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TAX REFORM, TAX RATES, AND TAX REVENUES

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TAX REFORM, TAX RATES, AND TAX REVENUES

TUESDAY, APRIL 23, 1985

CONGRESS OF THE UNITED STATES,
SUBCOMMITTEE ON MONETARY AND FISCAL POLICY
OF THE JOINT ECONOMIC COMMITTEE,
Washington, DC.

The subcommittee met, pursuant to notice, at 10 a.m., in room SD–G50, Dirksen Senate Office Building, Hon. James Abdnor (vice chairman of the Joint Economic Committee) presiding.

Present: Senators Abdnor, Mattingly, and D'Amato; and Representative Fiedler.

Also present: Christopher J. Frenze, professional staff member.

OPENING STATEMENT OF SENATOR ABDNOR, VICE CHAIRMAN, JOINT ECONOMIC COMMITTEE, PRESIDING

Senator ABDNOR. I would like to welcome the distinguished panel testifying before us this morning. This hearing on tax reform, tax rates, and tax revenues will explore the impact of the Economic Recovery Tax Act on taxpayer behavior and the implications for tax reform.

Today, there isn't much disagreement about the harmful economic consequences of high marginal tax rates. Everyone from Congressman Jack Kemp to Senator Bill Bradley agrees that they undercut incentives to work, save, and invest, and, thereby, lower economic growth and American living standards. I think virtually all of the tax reforms have great merit insofar as they would reduce marginal tax rates. Reform is urgently needed to reduce the tax impediments to economic expansion and to curtail tax-driven decisionmaking.

During the late 1960's and the 1970's, inflation-induced bracket creep pushed more and more taxpayers into the high tax brackets previously reserved for the very wealthy. The available evidence suggests that this spawned an explosion in tax avoidance activities of all kinds. For example, reported losses from farming, partnerships, professional practices, small business corporations, and other sources have multiplied to more than 10 times their level in the mid-1960's. Other forms of tax avoidance have also exploded in the last 15 to 20 years.

One of the worst features of the Tax Code is this incentive that high marginal tax rates give to tax avoidance and evasion. A staggering amount of time and energy is wasted manipulating the Tax Code to minimize tax liability. Tax aversion can have an especially negative impact on particular sectors as, for example, agriculture. In this industry, nonfarm tax-sheltered investors are putting bona

fide farmers out of business. If we lower marginal tax rates enough and broaden the tax base, we could remove much of the motivation for this tax avoidance activity.

Furthermore, as chairman of the Appropriations Subcommittee on Treasury, Postal Service, and General Government, I am keenly aware of the huge revenue losses resulting from tax evasion. Excessive tax rates are undermining civic morality and endangering the basis of our income tax system. As much as $95 billion a year may be lost to the Treasury because of tax evasion. Tax reform could make such evasion unattractive by lowering tax rates.

This morning we will hear expert testimony on how changes in marginal tax rates affect taxpayer behavior. These statements should make a solid contribution to our understanding of tax reform issues.

Senator Mattingly, I know you are one of the real tax experts in the Congress. Do you have a statement to make?

OPENING STATEMENT OF SENATOR MATTINGLY

Senator MATTINGLY. Thank you, Senator Abdnor. I have been a contributor for 54 years to the Federal Treasury. I think I would need greater encouragement if I didn't contribute as much. This is what this hearing is all about. Our Federal tax laws are too complex. I think they do need to be simplified. Inequities must be corrected and loopholes closed. We must not, however, increase the tax burden for the taxpayer.

Moreover, I think we need to find out what deductions have to be maintained in order to encourage home ownership, charitable contributions, and capital investment on the part of business. In other words, I think if people are going to reform the Tax Code we must reform it by making certain that we encourage the private sector, not discourage it.

I think there's a lot of support for tax simplification and fairness west of the Potomac. I am not sure about here.

But I would hope what you would address today, Senator Abdnor, that I think we need to see what kind of tax policy is most conducive to saving, investment, business formation and expansion, increased productivity, and risk taking.

I hope all of you would address these issues. I am all for making sure that we are revenue neutral. But I don't want to get so bogged down in understanding that we have a complicated, unfair Tax Code, and that we need a simple and fair Tax Code. I hope we don't forget what we are really trying to do.

I think if you look at history, and I hope you will all discuss the history and effects of the 1981 Tax Act, I think we will see that with lower rates come all of the positive economic results that I have mentioned.

The only other thing I hope they would address is the grandfathering of Tax Code provisions. I appreciate you holding this hearing, Senator Abdnor. I hope we can make more progress in lowering tax rates and that all of you will agree that this is the year to do it. Thank you, Senator Abdnor.

Senator ABDNOR. Thank you. Very good.

We are happy to say we have been joined by Congresswoman Fiedler, a member of our committee, and we appreciate that you have come a long way to take part in this. We welcome you. Do you care to make a statement?

Representative FIEDLER. No; thank you. I would be happy to listen to the testimony of the people on the panel. Thank you.

Senator ABDNOR. We certainly have an excellent panel to hear from this morning. We feel fortunate to bring these four individuals together. We will start out on my left. Mr. Gwartney, do you want to lead off this distinguished panel here?

STATEMENT OF JAMES GWARTNEY, PROFESSOR OF ECONOMICS AND POLICY SCIENCES, FLORIDA STATE UNIVERSITY, TALLAHASSEE

Mr. GWARTNEY. Thank you, Senator. It's a pleasure to have an opportunity to share my analysis, particularly the 1981-83 data, and it's a pleasure to be on such a distinguished panel as this. Actually I should be perhaps a little bit relieved that you called on me first. Really if Richard Rahn and Craig Roberts and Richard Vedder had preceded me there probably would not have been much for me to say. So I can breathe a sigh of relief at that point.

I really have only short introductory remarks. I, of course, will have my prepared statement put in the record.

Senator ABDNOR. Your entire statement will be made a part of the record.

Mr. GWARTNEY. I would like to make three points. First, I will deal with the distributional issue—the impact the tax changes of 1981 and 1983 had in tax burden across income groupings. Second, I will emphasize what I feel is a proper interpretation of the Laffer curve analysis. Third, I will look at some of the evidence with regard to the impact of tax changes on tax shelter activities.

While most commentators charged that the 1981 tax legislation would shift the tax burden to the poor, a handful of economists, including each member of this panel, argued that this view was fallacious. Basing their views on the structure of incentives emanating from a proportional tax cut and the historical experience of tax cuts during the 1920's and mid-1960's, these economists argued that lower tax rates would reduce tax shelter activities, lead to rapid expansion in taxable income, particularly in the upper brackets, and increase the share of tax revenue collected from the rich.

There is nothing mysterious about why roughly proportional rate reductions increased the share of revenue collected in the upper income tax rate brackets.

Analysis of differential incentive effects—the differential impact on take-home pay, which is, after all, what motivates us to work—makes this point clear.

Consider the impact of a rate reduction from 70 to 50 percent on the incentive of a high income professional or a business executive to earn taxable income.

When confronting a 70-percent marginal rate, the taxpayer gets to keep only 30 cents of each additional dollar earned by cutting costs, producing more, or investing more wisely.

But after the tax cut, take-home pay leads to an increase of 50 cents for each dollar earned, a whopping increase of 67 percent in the incentive to earn. Predictably, the taxpayer will spend less time figuring out how to hide income in tax shelters and more time figuring out how to cut business costs and increase sales.

Now, in contrast with the case of that upper income bracket person, consider the incentive effects on an identical percentage rate reduction in lower tax brackets. Suppose the 14-percent marginal rate was cut to 10 percent. Take-home pay per dollar of additional earnings expands from 86 to 90 cents, only a 5-percent increase in take-home pay.

Compared to the incentive effects in the upper brackets, the same percentage tax cut in the lower tax brackets leads to a much smaller increase in take-home pay and therefore a much smaller increase in the incentive to earn.

This differential incentive effect explains why a tax cut such as we had in 1981 to 1984, and then previously in the mid-1960's, actually shifts the tax burden to high income persons, because it increases the incentive to earn most in precisely these brackets. Of course, this is precisely what happened in the 1920's and again in the mid-1960's.

The 1983 individual data now permit us to investigate this issue once again. Once again, the findings are consistent with the incentives matter view.

During 1981–83 the income tax liability of high income taxpayers rose, while the tax liability of other taxpayers fell. Exhibit 1 of my prepared statement illustrates this point. In 1983, the top 10 percent of earners paid 50.5 percent of the total tax liability, up from 48.2 percent in 1981.

As exhibit 3 of my prepared statement illustrates, the share of the total income tax liability collected from high income taxpayers was larger in 1983 than at any time during the last 15 years. Far from a reverse Robin Hood process, as some have charged, the 1981 tax legislation might more accurately be described as the tax cut that really soaked the rich.

Turning to analysis or some reflections on the Laffer curve, in the past, the discussions of the Laffer curve have generally focused on the link between overall changes in tax rates and aggregate tax revenues. Such aggregative analysis is misleading, because it conceals the fact that there is a series of tax base elasticities—that is, responsiveness of the tax base to changes in rates across income groupings—rather than a single tax base elasticity that applies to all income groupings.

An analysis of changes and incentives, as we previously discussed, indicates that the tax base will be more responsive to rate changes in the upper brackets. Prior research by James Long of Auburn University and myself, along with the 1981–83 tax data, indicates that lower rates exert relatively less impact upon the tax base in the lower income and marginal rate tax categories.

In contrast, that is not the case in the upper brackets. In the upper income and tax brackets, changes in tax rates lead to substantial changes in the tax base.

The rapid 1982–83 increase in adjusted gross income and tax liability of taxpayers whose marginal rates were lowered as a result

of the imposition of the tax ceiling. The lowering of the ceiling from 70 percent to 50 percent, illustrates this point.

Measured in constant dollars, this group which comprised the top 1.36 percent of taxpayers, paid more taxes in 1983 than in 1981, even though their rates were lowered sharply. This indicates that they were and perhaps still are on the backward-bending portion of their Laffer curve.

Finally, let me address the issue of the impact of the lower rates on tax shelters. Economic theory, of course, suggests that lower tax rates make tax shelter activities which result in paper or accounting losses less attractive than otherwise would be the case. Therefore we would expect some opting out of tax shelters as the marginal tax rates are reduced. The 1983 tax data show that the trend toward larger and larger accounting losses has been reversed by the lower marginal rates. Thus it is consistent with the theory. Net income minus net losses in income categories such as partnerships, small business corporations, and business and professional practices are sensitive to tax shelter activities. Thus if we want to see what is happening in tax shelters, these are major categories that we would want to look at.

As exhibit 5 of my prepared statement illustrates, net income in these categories declined steadily as bracket creep increased tax rates throughout the 1970's. That trend reversed in 1983. For the first time in several years, net income from the sources most influenced by tax shelter activities rose relative to the previous year in 1983.

However, it takes time for taxpayers to alter their investment patterns, to move funds from tax shelters into higher yield investment opportunities. As more and more taxpayers are convinced that the lower rates are here to stay, and as they have time to adjust, more fully, their asset holdings, predictably still more funds will shift away from tax shelter investments. Thus the long-run expansion in the tax base will be greater than what we have observed in the short-run period between 1981 and 1983.

In fact, you already are starting to see articles in popular media such as the Wall Street Journal, Time, and Newsweek about the hard times of the tax shelter industry. This is precisely what we would expect as the lower marginal rates make such activities less attractive.

Finally, as Senator Abdnor emphasized, the real issue is economic efficiency rather than distributional patterns. Of course, that's why the tax shelter issue is so important.

So, let me make myself clear that the reason why we are interested in the microanalysis of the tax shelter and distributional impacts really relates to economic efficiency.

Certainly the 1981–83 data strengthen the case for lower marginal rates. Hopefully the revised Treasury plan will include a top rate no higher than 30 percent. High marginal rates are a major source of economic waste. In contrast, low marginal rates will improve the efficiency of our resource use and provide the foundation for a stronger economic growth.

One final point relating to tax reform. As lower tax rates shift funds from tax shelter investments into the organized loanable funds market—that is, the stock and bond markets—predictably

real interest rates will decline because of increases in the supply of funds to the organized loanable funds market. In addition, if limitations on interest deductibility other than for home mortgages are also adopted and the tax-free status of private use municipal bonds is eliminated, as has been widely proposed, the demand for loanable funds will also decline, placing still more downward pressure on interest rates. This combination of increase in supply of funds, as funds shift into the organized loanable funds market, and reduction in demand for funds for certain kinds of activities which are financed by borrowing, will predictably lead to downward pressure on interest rates.

Of course I do not have to tell this committee that lower interest rates mean a reduction in annual Federal interest payments of approximately $15 billion for each 1 percent reduction in interest rates. Thus tax reform promises not only to improve economic efficiency, but it will also reduce Government expenditures as a result of lower interest rates.

There is not a conflict, as some have charged, between budgetary policy and tax reform. Logically, tax reform should be viewed as an integral part of any expenditure reduction strategy. Thank you, Senator Abdnor.

Senator ABDNOR. Thank you.

[The prepared statement of Mr. Gwartney follows:]

PREPARED STATEMENT OF JAMES GWARTNEY

The Impact of the 1981-1984 Tax Cuts

This paper considers four issues related to the impact of the 1981-1984 reductions in tax rates. First, the impact of the lower rates on the distribution of the tax liability across income groups is investigated. Second, we analyze the major income components influenced by tax shelter activities in order to determine if there is any evidence of movement away from tax shelter investments. Third, the appropriateness of static revenue projections is considered in light of our findings. Finally, the impact of tax policy on economic growth is addressed.

I. The Changing Distribution of the Tax Burden

When the 1981 tax rate reductions were passed, many commentators referred to the legislation as welfare for the rich. Some even charged that the legislation was "a reverse Robin Hood process, taking from the poor and giving to the rich." Simultaneously, a handful of economists argued this was nonsense--that far from shifting the burden of the income tax to the poor the legislation would actually increase the share of revenue collected from high income taxpayers. For example, Richard Stroup of Montana State and I co-authored a paper published by the Federal Reserve Bank of Atlanta in March 1982, in which we stated, "Predictably a more rapid expansion

of the tax base (taxable income) in the upper brackets will lead to an increase in the share of income tax revenue collected from high income groups."[1]

The recently released 1983 individual income tax data permit one to investigate the validity of the two alternative views as to the distributional impact of the 1981 tax legislation. However, before we look at the numbers, let us analyze what economic theory has to say about the issue. There is nothing mysterious about why roughly proportional tax rate reductions increase the share of revenue collected in the upper income (and tax rate) brackets. Analysis of the differential incentive effects--the differential impact on take-home pay--makes this point clear. Consider the impact of a rate reduction from 70 percent to 50 percent on the incentive of a high income professional or business executive to earn taxable income. When confronting a 70 percent marginal rate, the taxpayer gets to keep only 30 cents of each additional dollar earned by cutting costs, producing more, or investing more wisely. But after the tax cut, take-home pay from each dollar of taxable income jumps to 50 cents--a whopping 67 percent increase in the incentive to earn more. Predictably, this taxpayer will spend less time figuring out how to hide income in tax shelters and more time finding ways to cut business costs and increase sales.

In contrast, consider the incentive effects of an identical percentage rate reduction in lower tax brackets. Suppose the 14 percent marginal rate was cut to 10 percent. Take-home pay per dollar of additional earnings

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[1]James Gwartney and Richard Stroup, "Tax Cuts: Who Shoulders the Burden?," Economic Review, Federal Reserve Bank of Atlanta, March 1982, p. 27.

expands from 86 cents to 90 cents, only a 5 percent increase. Compared to the incentive effects in the upper brackets, the same percentage tax cut in the lower tax brackets leads to a much smaller increase in take-home pay and thus a much smaller increase in the incentive to earn more taxable income.

Since most of us are motivated by after-tax earnings, proportional rate reductions will increase the incentive to earn more (and shelter less) income primarily in the upper marginal tax brackets. As a result, taxable income will grow most rapidly in these brackets, increasing the share of taxes collected from high income recipients.

The distributional impact of the tax cuts during the 1920s and again in the mid-1960s was highly consistent with this theory. As the top rate was slashed from 73 percent in 1921 to only 25 percent in 1926, both the real dollar and relative share of taxes collected from high income taxpayers rose. Similarly, in the two years following the 1964-1965 rate reductions, tax revenue collected from the top 5 percent of earners rose by 7.7 percent, while the tax liability of all other income groups fell.[2] Thus, buttressed by economic theory and the evidence from two prior tax cuts, supply-side economists could confidently predict that the 1981-1984 rate reductions would also shift the burden of the income tax to the rich, even though theirs was a minority view at the time the legislation was instituted.

Both inflation and expanding income push an increasing share of taxpayers into upper nominal income brackets. Thus, as other commentators have correctly pointed out, it is potentially misleading to compare income shares and

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[2]Ibid., pp. 19-27.

tax liabilities above specified income cutoffs (for example, above $50,000) at two points in time.[3]

In order to avoid bias resulting from bracket creep and income growth, data should be organized in a manner that will maintain an equal percent of taxpayers in each group when making comparison across time. Exhibit 1 presents tax liability data for 1981 and 1983 organized in this manner. Measured in current dollars, the tax revenue collected from the top 10 percent of taxpayers rose from $137.0 billion in 1981 to $139.4 in 1983, an increase of 1.8 percent. Adjusted for inflation, the real tax liability of the top 10 percent of earners fell by 6.9 percent between 1981 and 1983, substantially less than the 18 percent rate reduction during the period.

The top 1.36 percent of taxpayers is of particular interest. This group consists of taxpayers reporting an adjusted gross income (AGI) of more than $75,000 in 1981 (and more than $85,300 in 1983). Given normal deductions, these taxpayers confronted marginal rates in excess of 50 percent prior to 1982. Beginning in 1982, they received not only an across-the-board tax cut, as did all taxpayers, but they also benefited from the reduction in the top rate ceiling from 70 percent to 50 percent. This group encompasses precisely "the rich" who received the big rate reductions. Just as economic theory suggests, lowering the extremely high rates led to a rapid expansion

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[3]In 1981, 4.3 percent (4.1 million) of the personal returns reported an adjusted gross income (AGI) of $50,000 or more. By 1983 the number of returns reporting AGI of $50,000 or more had jumped to 5.5 percent (5.3 million). Taxpayers with an AGI of $50,000 or more paid 39.6 percent of the total tax liability in 1983, up from 33.2 percent of the total in 1981. However, some of this increase simply reflects the expansion in the relative share of high income returns due to inflation and normal real income growth. Since we make comparisons only between identical percentages of returns across tax years, we are able to avoid this bias and thus more carefully isolate the impact of changes in incentives emanating from the tax cut.

Exhibit 1: The Change in Federal Income Taxes Collected from Various Income Groups, 1981-1983

Income Groups Ranked from High to Low[a]	Tax Liability (in billions) 1981	1983	Percent Change
In Current Dollars			
Top 10% of Earners	$137.0	$139.4	+ 1.8
Top 1.36%	58.0	64.9	+11.9
Next 40% of Earners	126.5	117.7	- 7.0
Bottom 50% of Earners	20.6	19.0	- 7.8
Total	$284.1	$276.1	- 2.8
In 1981 Dollars			
Top 10% of Earners	$137.0	$127.6	- 6.9
Top 1.36%	58.0	59.4	+ 2.4
Next 40% of Earners	126.5	107.8	-14.8
Bottom 50% of Earners	20.6	17.4	-15.5
Total	$284.1	$252.8	-11.0

[a]The income ranges for each of the groups were:

	Top 1.36%	Top 10%	Next 40%	Bottom 50%
1981	>$75,000	>$38,630	$13,850-$38,630	<$13.850
1983	>$85,300	>$41,500	$14,890-$41,500	<$14,890

Source: The 1981 data are from the Internal Revenue Service, Individual Income Tax Returns: 1981 Statistics of Income. The 1983 data are from the Internal Revenue Service, "Preliminary Income and Tax Statistics for 1983 Income Tax Returns," SOI Bulletin: Statistics of Income, Winter 1984-85, pp. 19-30. When necessary interpolation (income weighted method) was used to derive the tax liability within income groups. The consumer price index was used to adjust for inflation.

in AGI. Thus, the top 1.36 percent of taxpayers (approximately 1.3 million returns) paid $64.9 billion in income taxes in 1983, up from $58.0 billion in 1981, an increase of 11.9 percent. Even when measured in constant dollars, the tax liability of this group of high income taxpayers rose from $58.0 billion in 1981 to $59.4 billion in 1983, an increase of 2.4 percent in spite of sharply lower rates. For this segment of the population, the backward bending Laffer Curve analysis is alive and well.

The data for other income groups also conform to expectations. Since the rate reductions led to smaller increases in take-home pay per dollar of additional taxable income in other tax brackets, a smaller change in the tax base was a predictable outcome. For taxpayers with incomes between the 50th and 90th percentile, tax liability fell from $126.5 billion in 1981 to $117.7 billion in 1983, a reduction of 7 percent. Measured in real dollars, the tax liability of this group fell by 14.8 percent, not too much different from the 18 percent reduction in rates.

The tax liability of the bottom half of income recipients also declined sharply. In current dollars, the tax liability of this group fell from $20.6 billion in 1981 to $19.0 billion in 1983, a reduction of 7.8 percent. Adjusted for inflation, the tax liability of the bottom half of income recipients declined by 15.5 percent.

Exhibit 2 illustrates how these changes affected the relative size of the tax liability across income groupings. In 1983, the top 10 percent of earners paid 50.5 percent of the total income tax liability, up from 48.2 percent in 1981. The increase in the relative share of the top 1.36 percent of high earners was even greater. This small group of elite taxpayers

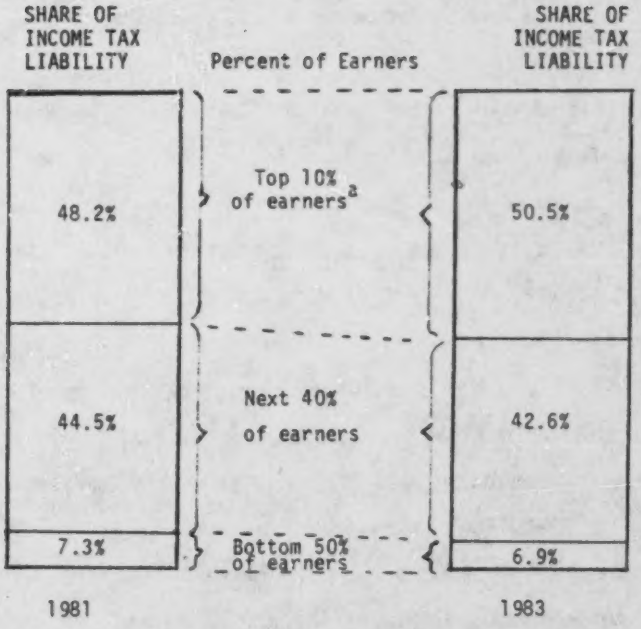

Exhibit 2: The Share of the Income Tax Liability Paid by High-Income Taxpayers Increased Between 1981 and 1983

[a]The share of the income tax liability paid by the top 1.36 percent of earners rose from 20.4 percent in 1981 to 23.5 percent in 1983.

Source: See Exhibit 1.

paid 23.5 percent of the federal income tax in 1983, compared to 20.4 percent in 1981.

While the relative share of the tax liability shouldered by high earners increased between 1981 and 1983, the tax burden of others declined. The tax liability of earners in the 50th to 90th percentile group fell from 44.5 percent of the total in 1981 to 42.6 percent in 1983. Similarly, the bottom half of earners also paid a relatively smaller share of the income tax liability, 6.9 percent in 1983, down from 7.3 percent in 1981.

Exhibit 3 places the 1983 share of tax liability borne by high income taxpayers in historical perspective. Throughout the 1970s, the top 1.36 percent of taxpayers carried between 20 and 22 percent of the total income tax liability. In 1983, the proportion of the total income tax liability collected from the top 1.36 percent jumped to 23.5 percent.

A similar pattern was present for the top 10 percent. While the top 10 percent of earners paid 48 to 49 percent of the total income tax liability throughout most of the 1970s, the share collected from them rose to 50.5 percent in 1983. These data illustrate that the share of income taxes collected from high income taxpayers in 1983 was larger than at any time during the last 15 years. Far from a reverse Robin Hood process, the 1981 tax legislation might more accurately be described as the tax cut that soaked the rich.

Appropriate Way of Viewing the Laffer Curve

In the past, discussions of the Laffer Curve have generally focused on the relationship between across-the-board changes in the tax rates and aggregate tax revenues. When one focuses on the aggregate data, it is clear that the United States is on the upper sloping portion of the Laffer

Exhibit 3: The Income Tax Liability of High Income Taxpayers as a Percent of the Total, 1970-1983

	Income Tax Liability (billions)	Percent of Total Income Tax Liability
Top 1.36% of Earners		
1970	$17.5	20.4
1975	26.9	21.6
1978	40.1	21.3
1980	54.3	21.7
1981	58.0	20.4
1982	60.5	21.8
1983	64.9	23.5
Top 10% of Earners		
1970	38.9	45.3
1975	61.0	49.0
1978	93.6	49.7
1980	123.6	49.3
1981	137.0	48.2
1982	136.7	49.2
1983	139.4	50.5

Source: The 1970-1982 data were for the Internal Revenue Service, Individual Income Tax Returns: Statistics of Income (Annual). The 1983 data were from the Internal Revenue Service, SOI Bulletin: Statistics of Income, Winter 1984-85, pp. 19-30. When necessary, interpolation (income weighted method) was used to derive the tax liability within income groups.

Curve. The lower tax revenues, particularly when measured in real dollars, in 1982 and 1983 are consistent with this view. However, I believe the aggregate analysis is highly misleading. It conceals the fact that there is a series of tax base elasticities--that is, changes in taxable incomes emanating from changes in tax rates--across income groupings, rather than a single tax base elasticity that applies to all income groupings.

Under a progressive system, one group of taxpayers may well be on the upper sloping portion of the Laffer Curve while others are on the backward bending segment. This is precisely what the evidence indicates. For taxpayers confronting relative low marginal rates, say rates less than 30 percent, there is a positive relationship between changes in tax rates and tax revenues. For this group, 10 percent lower rates may well lead to approximately 10 percent less tax revenue.

However, this will not be the case in the upper income (and marginal tax rate) categories. In these brackets, a 10 percent decrease in tax rates will exert a much stronger positive impact on take-home pay. In turn, the positive incentive effects will induce high income taxpayers to earn more taxable income while engaging less intensively in tax shelter activities. Their tax base will expand, resulting in a less than proportional reduction in tax revenues as tax rates fall. At extremely high rates, say combined federal and state marginal rates in excess of 50 percent, lower (higher) tax rates will lead to an increase (a reduction) in the tax revenue collected from high income taxpayers.

The evidence from the 1981-1983 tax cut is highly consistent with this analysis. As previously noted, in 1983 tax rates were approximately 18 percent lower than in 1981. If one makes allowance for bracket creep,

the 1983 rates were approximately 15 percent lower for constant real incomes. For the bottom 95 percent of taxpayers (with incomes less than $53,000 in 1983), measuring in 1981 dollars the tax liability fell from $183.7 billion to $156.4 billion, a 14.9 percent decline. Thus, for this group of taxpayers, the reduction in tax rates led to approximately a proportional reduction in tax revenues. For these taxpayers, there is little evidence that lower rates exert a significant positive impact on the tax base, at least in the short run.[4]

But this is not true in the upper brackets. For the top 5 percent of taxpayers (those with incomes above $53,000 in 1983), the 15 percent reduction in real tax rates led to only a 4.0 percent decline in real tax revenue. For the top 1.36 percent of taxpayers, real tax revenues actually increased by 2.4 percent between 1981 and 1983, in spite of the substantial reduction in tax rates. Thus, in the upper tax brackets, the 1981-83 data

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[4]The chart below indicates how the tax liability, measured in dollars of constant purchasing power, changed for various income groupings during 1981-1983.

	Tax Liability (billions of 1981 dollars)		
	Top 5%	Top 1.36%	Bottom 95%
1981	$100.4	$58.0	$183.7
1982	95.1	57.1	166.8
1983	96.4	59.4	156.4
Percent change 1981-1983	-4.0	+2.4	-14.9

Given that real AGI (and GNP) was approximately the same in 1983 and 1981, these data illustrate that the real tax liability of the top 5 percent of earners declined much less than tax rates, while the revenue reductions for the bottom 95 percent of earners were approximately proportional to the real tax rate reductions.

indicate that the lower rates led to an abnormally large expansion in the tax base which largely offset the negative impact of the lower rates on tax revenue.

From the standpoint of tax policy, two important findings emerge. First, the income tax base of taxpayers with adjusted gross incomes of less than $40,000 and marginal tax rates of less than 25 percent is not very responsive to changes in tax rates. For these taxpayers, lower tax rates will lead to an approximately proportional reduction in tax revenue. Second, the tax base in the upper brackets is quite responsive to rate changes. Thus, the top marginal rates can be reduced, perhaps to as low as 35 percent as recommended by the Treasury plan, without significant loss of tax revenue.

II. The 1983 Decline in Tax Shelter Activity

Economic theory emphasizes that lower tax rates will encourage movement of investment funds out of tax shelters and into higher return projects which yield taxable income. This process promotes a more efficient allocation of investment resources and expands the size of the economic pie. While the adjustment process takes time, the data indicate that the process was well underway by 1983.

Exhibit 4 presents data on the composition of income for the top 1.36 percent of earners, a group which experienced a substantial increase in the incentive to earn taxable income relative to tax shelter income during 1981-1983. Just as the theory predicts, both the AGI and taxable income of these taxpayers increased quite rapidly, 22.1 percent and 24.0 percent

Exhibit 4: The Composition of Income for the Top 1.36 Percent of Earners - 1981 and 1983

	Top 1.36 Percent of Earners (billions)		
	1981	1983	Percent Change
Number of Returns (thousands)	1300.2	1312.4	+ 0.9
Income Range AGI greater than:	$75,000	$85,300	--
Adjusted Gross Income (billions)	$ 177.0	$ 216.1	+22.1
Salaries and Wages	$ 102.3	$ 125.4	+22.6
Major Sources of Income Influence by Tax Shelter Activities	14.3	20.1	+40.6
Business and Professional	11.0	12.3	
Rents	1.3	0.2	
Farm	-0.7	-0.9	
Partnership	2.0	3.6	
Small Business Corp.	0.7	4.9	
Savings Income	45.7	48.0	+ 5.0
Interest	21.0	20.0	
Dividends	18.2	20.1	
Royalties	3.0	3.0	
Estate and Trust	1.6	2.0	
Pensions and Annuities (in AGI)	1.9	2.9	
All Other AGI	14.7	22.6	+53.7
Taxable Income	138.2	171.3	+24.0
Income Tax Liability	58.0	64.9	+11.9

Source: The 1981 data are from the Internal Revenue Service, Individual Income Tax Returns: 1981 Statistics of Income. The 1983 data are from the Internal Revenue Service, "Preliminary Income and Tax Statistics for 1983 Income Tax Returns," SOI Bulletin: Statistics of Income, Winter 1984-85, pp. 19-30. When necessary, interpolation (income weighted method) was used to derive the tax liability within income groups.

respectively, during 1981-1983. These growth rates were almost double the 13 percent growth rate of nominal GNP.

The composition of the rapid growth in taxable income is most enlightening. The most rapid growth was in precisely those categories most influenced by tax shelter activities. Businesses, partnerships, and ownership of depreciable assets are the major vehicles used to shelter income from the IRS. The top 1.36 percent of taxpayers derived $20.1 billion of income from business and professional practice, rents, farming, partnerships, and small business corporations in 1983, up from $14.3 bilion in 1981--an increase of 40.6 percent in just two years. Similarly, income derived from salaries and wages rose from $102.3 billion in 1981 to $125.4 billion in 1983, an increase of 22.6 percent. Responding to the lower tax rates, these data indicate that high income executives spent more time and energy earning taxable income in 1983 and less time figuring out how to shelter it from the IRS. In addition, owners of enterprises no doubt funneled less potential wage and salary income into fringe benefits, pension plans, and business expenditures providing personal consumption benefits (business vacations, luxury offices, new automobiles, etc.), as lower tax rates reduced the attractiveness of this strategy.

While detailed data according to income group are not yet available, it is clear that capital gains also contributed to the expansion of the taxable income base. Capital gains are the major item included in the "all other AGI" category in Exhibit 4. Thus, the 53.7 percent increase in income in this category (from $14.7 billion in 1981 to $22.6 billion in 1983) in large part reflects large increases in capital gains income.

In the past, some critics have acted as if the growth of capital gains income was an unfortunate happenstance. From the viewpoint of economic theory, this is not the case. The boom in stock and bond prices following the tax cut was no coincidence. Lower tax rates increase the value of assets such as stocks and bonds which yield taxable returns. Simultaneously, the lower rates reduce the value of investments yielding short-term accounting losses and long-term appreciation. Thus, the current depressed state of real estate partnerships and other tax shelter investments is also a reflection of tax policy. From a supply-side standpoint, these changing market conditions are not at all unfortunate. In fact, they are precisely the desired response--a movement of resources away from investments based on favorable tax treatment and toward those yielding higher real returns.

The impact of lower tax rates on tax shelter activities is also observable from the data of Exhibit 5. Here we provide a graphic illustration of aggregate net income (less losses) from the five major categories influenced by tax shelter activities. As the data show, throughout the 1970s and particularly during the post 1978 period, net income from businesses, partnerships, farming, and rents fell sharply, as more and more taxpayers opted for shelter as bracket creep confronted them with higher marginal rates. By 1982, measured in 1983 dollars, aggregate taxable net income from these five categories had fallen to $31.8 billion, down from $126.8 billion in 1973. However, as the lower rates took effect and taxpayers were convinced that taxes were not going to be raised in the foreseeable future, the long-term decline in net income was finally arrested in 1983. As more and more individuals adjust their portfolios with the passage of time, additional movement

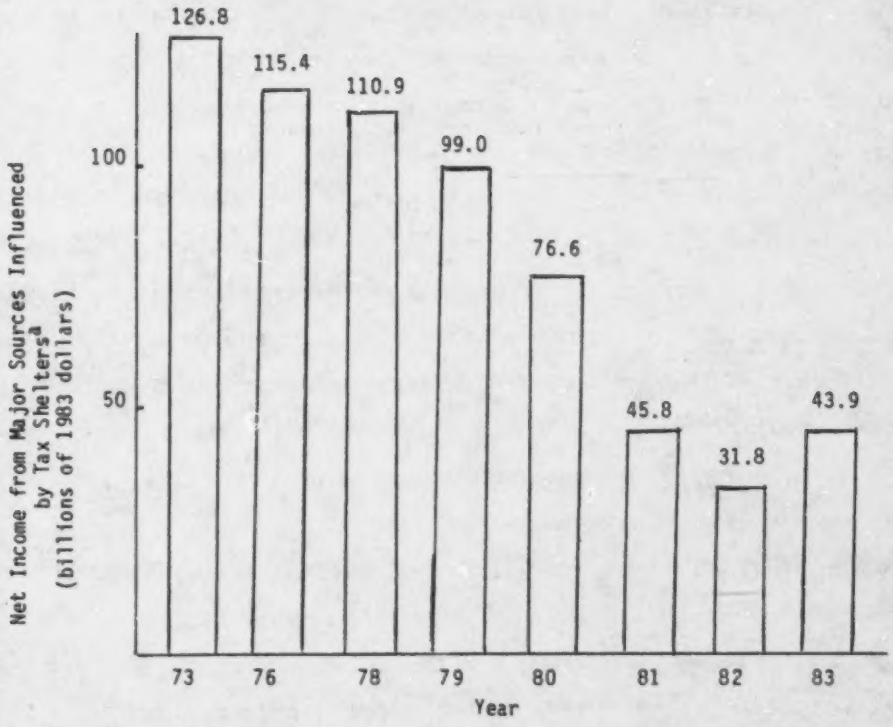

Exhibit 5: Lower Marginal Rates and Reversing the Tax Shelter Boom

[a]The net income less net losses from the following sources are included: business and professional practice, farming, partnerships, small business corporations, and rents. See Appendix for details.

out of tax shelter investments will predictably contribute to future income growth in these categories.

Upper Income Gains - The Correct Interpretation

Economic theory indicates that changes in incentives emanating from a roughly proportional rate reduction will exert their greatest impact in the upper income and tax brackets. Thus, during the period following a tax cut, one would expect the most rapid gains in taxable income in the upper brackets. As Exhibit 5 illustrates, the 1981-1983 period is consistent with this view. The adjusted gross income of the top 1.36 percent of taxpayers rose 22.1 percent (11.8 percent in real terms) between 1981 and 1983, a phenomenal growth rate considering the depth of the 1982 recession in the midst of the period. The AGI of the broader top 10 percent grew an impressive 13.4 percent (3.8 percent in real terms) between 1981 and 1983. As expected, the bottom 90 percent of earners registered a more modest 8.5 percent gain in AGI. Reflecting the recessionary conditions of the early part of the period, the real AGI of the bottom 90 percent of earners was slightly (0.7 percent) lower in 1983 than 1981.

No doubt, some commentators will point to the rapid growth of income in the upper brackets and argue that "the rich are getting richer while the poor are getting poorer." However, it is clear that these distributive effects are more apparent than real. The rapid growth of income in the top brackets reflects the declining attractiveness of concealing income via capital appreciation, non-taxable fringe benefits, and deductible business expenditures that yield personal utility. Prior to the tax cut, a larger proportion of income, particularly in the upper brackets, was concealed because it was realized via such tax shelter mechanisms. After the tax

Exhibit 6: The Change in Adjusted Gross Income for Various Income Groups Between 1981 and 1983

Income Groups Ranked from High to Low	Adjusted Gross Income (billions) 1981	1983	Percent Change
In Current Dollars			
Top 10% of Earners	$ 575.4	$ 652.3	+13.4
Top 1.36%	177.0	216.1	+22.1
Next 40% of Earners	903.5	983.6	+ 8.9
Bottom 50% of Earners	293.7	314.9	+ 7.2
In 1981 Dollars			
Top 10% of Earners	575.4	597.2	+ 3.8
Top 1.36%	177.0	197.9	+11.8
Next 40% of Earners	903.5	900.6	- 0.3
Bottom 50% of Earners	293.7	288.3	- 1.8
Total	$1,771.6	$1,786.2	0.8

Source: The 1981 data are from the Internal Revenue Service, Individual Income Tax Returns: 1981 Statistics of Income. The 1983 data are from the Internal Revenue Service, "Preliminary Income and Tax Statistics for 1983 Income Tax Returns," SOI Bulletin: Statistics of Income, Winter 1984-85, pp. 19-30. When necessary, interpolation (income weighted method) was used to derive the tax liability within income groups.

cut, this strategy was less profitable. Less income was concealed and more reported. Thus, much of the growth of observed income in the top brackets reflects a decline in the proportion of untaxed income rather than an increase in real income, accurately measured.

In the Long Run, Shift from Tax Shelter Activities Will be Still Greater

Predictably, the effects of lower tax rates on the tax base will be greater in the long-run than in the short-run.[5] There are two major reasons why this is true. First, taxpayers must be convinced that the lower rates are permanent--that they will not be reversed in the near future. During 1982-1983 there was considerable uncertainty in this area. Until quite recently, powerful leaders in both major political parties argued that a tax increase was inevitable. The possibility of higher future taxes will slow the response of taxpayers to lower rates.

Second, it takes time for taxpayers to adjust their asset holdings to a new economic environment. Few taxpayers will sell their old tax shelter investments as an immediate response to lower tax rates. However, they will make fewer such investments in the future. With the passage of time, the proportion of taxpayer investments yielding taxable income will rise relative to projects designed for tax shelter purposes.

Given the time dimension of the adjustment process, several years will pass before the effects of the lower rates on the tax base will be fully realized. Future analysis of income composition in 1984 and 1985

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[5]See James M. Buchanan and Dwight Lee, "Politics, Time, and the Laffer Curve," Journal of Political Economy, August 1982, for analysis of this issue.

will almost certainly reveal an even greater movement of resources out of the tax shelter industry.

III. Implications for Static Revenue Projections

Future revenue expected from tax reform proposals such as the Kemp-Kaston, Bradley-Gephardt, and Treasury plan is almost always based on static revenue projections. Even though all of these plans will substantially reduce marginal tax rates, particularly the top marginal rates, the static revenue projections make no allowance for an expansion in the tax base emanating from the lower tax rates. As a result, our analysis indicates that static projections will systematically underestimate future tax revenue, particularly in the upper income (and tax rate) brackets.

How important is this underestimation? Prior research by James Long and myself using 1979 income tax data indicates that lower tax rates fail to significantly expand the tax base for gross incomes of less than $40,000 and federal marginal tax rates of less than 30 percent.[6] In contrast, we estimated long run tax base elasticities--the percent change in the tax base divided by the percent change in tax rates--of greater than unity for incomes above $90,000 and combined federal-state marginal rates in excess of 50 percent. When focusing on the top 10 percent of earners,

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[6]See particularly, James Gwartney and James Long, "Tax Rates, Tax Shelters, and the Efficiency of Capital Markets," in Dwight Lee (ed.), Taxes and Capital Markets (San Francisco: Pacific Institute, 1985); and James Long and James Gwartney, Income Tax Avoidance: Evidence from Individual Returns, Workshop paper: Policy Science Program, Florida State University, 1985.

our research would imply a long-run tax base elasticity of approximately 0.5.[7]

While the 1981-1983 data only permit one to estimate short-run elasticities, the responsiveness of the tax base to lower marginal rates is quite consistent with the prior research of Long and myself. The adjusted gross income of the bottom 90 percent of earners grew 8.4 percent between 1981 and 1983. As Exhibit 6 indicates, the AGI of the top 10 percent of earners expanded by 13.4 percent during the same period, an increase of 5 percent relative to the income gains of lower income taxpayers who confront lower marginal rates. This would suggest that the 1981-1983 rate reductions led to an additional 5 percent expansion in the tax base of the top 10 percent of earners. Given the approximately 15 percent lower real tax rates, this would imply a short-run tax base elasticity of .33 (5 percent additional AGI divided by the 15 percent rate reduction) for the top 10 percent of taxpayers. Thus, the abnormally rapid growth of the tax base in the upper brackets implies a short run tax base elasticity for the top 10 percent of earners that is not much different from the prior long run estimate of Long and myself derived via a completely different methodology.

These tax base elasticity estimates can be used to calculate the underestimation of future tax revenues stemming from the use of static revenue projections. Let us assume that the tax base elasticity is zero for the bottom 90 percent of taxpayers and between .33 and .50 for the top 10 percent

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[7]The methodology employed by Long and myself in our prior research permits us to estimate only the impact of tax avoidance on the tax base. Our estimates do not reflect the impact of tax rate induced changes in labor supply, tax evasion, and the substitution of non-taxed fringe benefits for taxable income. Thus, they may be downward bias.

of earners. These would appear to be rather conservative assumptions. If the marginal tax rates of the top 10 percent of earners are reduced by 25 percent (from a current average of 40 percent to a new average of 30 percent), the lower rates would lead to an expansion in the AGI of high income taxpayers of between $54 billion and $82 billion, compared to their expected AGI based on static revenue projections.[8] Given the top marginal rate of 30 percent, this additional AGI indicates that static revenue projections underestimate future tax revenues by between $16 billion and $25 billion per year. While these estimates are based on a number of assumptions, I believe they provide a realistic view of the underestimation involved in static revenue projections.

IV. Efficiency Is the Issue

While the distributive implications of the 1981-84 tax cut are interesting, they must not divert us from the real issue. High taxes, particularly high marginal rates, are harmful because they promote economic inefficiency and retard economic growth. High marginal tax rates waste resources by reducing the incentive of individuals to save, invest in human and physical capital, accept demanding jobs, and make other choices which generate taxable income. Instead, resources are channeled into less productive, tax-sheltered activities designed to generate accounting losses and/or transform ordinary income into future capital gains. Simultaneously, high marginal rates waste resources by inducing taxpayers to purchase deductible items even when they do not value them very highly. Deductibility makes the personal

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[8]This figure represents (a) the estimated tax base elasticities of either .33 or .50, multiplied by (b) the 25 percent rate reductions, multiplied by (c) the $652 billion AGI of the top 10 percent of earners in 1983.

cost cheap when taxpayers confront high marginal rates. But it does not reduce the real cost of producing the item. When taxpayers purchase deductible items they would not choose if they bore the full cost, resources are squandered and the size of the economic pie is reduced.

Finally, high marginal rates reduce the incentive of individuals to engage in productive activity--to help others in exchange for income. Lawyers, doctors, and other high income professionals spend more time on the golf course and less time with their clients. Secondary workers decide that their job is not worth the hassle when they get to keep only a fraction of every dollar earned. Negative-sum games are encouraged and positive-sum activities stifled. This is the real cost of high marginal tax rates. They reduce our growth rate and we are all worse off as a consequence.

There is evidence that the 1981-84 rate reductions were a step away from the negative-sum society. As Exhibit 7 shows, we have made substantial progress against both inflation and sluggish growth in recent years. Compared to other countries, our recent economic record is quite impressive. Since 1980, the inflation rate in the United States has fallen 7.2 percent, more than any other industrial nation except the United Kingdom. Simultaneously, the growth rate of real GNP during the 1982-1984(2) period was 4.5 percent, more rapid than for any other western industrial country.

The lessons of the 1981-1984 period are clear. Lower marginal tax rates will improve the efficiency of our resource use. The top marginal rates can be reduced without any great loss of tax revenue. Certainly revenue losses can easily be made up by eliminating the deductibility of state and local taxes and interest other than for home mortgages--items for which the case for deductibility is extremely weak anyway. Vigorous

Exhibit 7: Inflation and Economic Growth, Seven Industrial Nations

	Inflation (Annual Rate)			Annual Rate of Growth of Real GNP: 1982(1)-84(2)
	1980	1982-84(3)	Change	
United States	11.2	4.0	-7.2	+4.5
West Germany	5.6	3.0	-2.6	0.7
France	12.6	8.6	-4.0	1.3
Sweden	12.6	8.4	-4.2	1.7
Japan	6.6	1.9	-4.7	3.6
United Kingdom	12.8	4.9	-7.9	2.3
Canada	12.2	5.7	-6.5	2.5

Source: Federal Reserve Bank of St. Louis, International Economic Conditions, January 1985. The number in parentheses following the year indicates the quarter.

debate on alternative tax plans is entirely proper, but we must not allow minor skirmishes to distract us from the central focus. Substantially lower marginal rates--no higher than the 30 percent rate--will improve the efficiency of our resource use and provide the foundation for stronger economic growth. The 1983 tax data indicate the importance of getting on with such tax reform.

Appendix: The Reversal of the Declining Net Income from Major Tax Shelter Sources

Source	Net Income Less Net Loss from Major Tax Shelter Source							
	1973	1976	1978	1979	1980	1981	1982	1983
Current Dollars								
Business & Professional	38.6	44.4	53.5	56.6	55.1	53.1	50.6	58.8
Farm	7.2	3.5	3.6	2.1	-1.8	-7.8	-9.8	-8.6
Partnerships	11.2	12.2	15.0	12.5	9.4	-0.1	-0.9	0.2
Small Business Corp.	2.1	2.0	2.3	2.2	0.7	-0.8	-0.8	3.2
Rent	3.8	3.9	3.1	1.8	0.2	-2.8	-8.5	-9.7
Total	62.3	66.0	77.5	75.2	63.6	41.6	30.6	43.9
Constant 1983 Dollars								
Business & Professional	77.3	80.3	76.5	74.5	66.4	58.5	52.6	58.8
Farm	14.7	5.7	5.2	2.7	-2.1	-8.6	-10.2	-8.6
Partnerships	22.8	19.8	21.5	16.5	11.3	-0.1	-0.9	0.2
Small Business Corp.	4.3	3.3	3.3	2.9	0.8	-0.9	-0.9	3.2
Rent	7.7	6.3	4.4	2.4	0.2	-3.1	-8.8	-9.7
Total	126.8	115.4	110.9	99.0	76.6	45.8	31.8	43.9

Source: The 1970-1982 data were for the Internal Revenue Service, Individual Income Tax Returns: Statistics of Income (Annual). The 1983 data were from the Internal Revenue Service, SOI Bulletin: Statistics of Income, Winter 1984-85, pp. 19-30. When necessary, interpolation (income weighted method) was used to drive the tax liability within income groups.

Senator ABDNOR. Our next witness will be Mr. Vedder. We are again very happy to have you here.

STATEMENT OF RICHARD K. VEDDER, PROFESSOR OF ECONOMICS, OHIO UNIVERSITY, ATHENS

Mr. VEDDER. Thank you. Thank you, Senator Abdnor. I am happy to be here as an alumnus of the Joint Economic Committee. It's good to be back.

I was going to speak at some length about the 1981–83 tax data, and the effects of the 1981 tax cut on economic activity. I think Jim Gwartney has in many ways summarized some of that. Let me make three points this morning. The first point I wanted to make was to answer Senator Mattingly's question, although this is perhaps not the appropriate time to do so.

Clearly, as Professor Gwartney indicated, the absolute critical thing in any revision of the Tax Code is lowering marginal tax rates. I would add the word "effective" marginal tax rates. I will come back to what that word means in a little bit.

Anything else that is done is maybe useful and nice and what not, but the critical thing, the dominant thing, is the lowering of the marginal rates as the recent historical experience, not to mention the old historical experience, tells us.

I have told this story 6 months ago in the Joint Economic Committee study. There is attached to my prepared statement a Wall Street Journal story which details the 1981–83 data which makes the same point.

It is interesting to note that since 1981, during the middle of the worst recession in 40 years, the number of millionaires more than doubled in the United States. Mysteriously, in the middle of 10 percent unemployment, the number of millionaires suddenly doubled and the amount of tax payments from millionaires went up 108 percent from 1981 to 1983.

This is not a mystery to me. It is a mystery with some people at the Urban Institute and in the Congressional Budget Office and other places where they haven't learned the law of supply. But it isn't a mystery to any member of this panel or anyone who has had any elementary training in economics and who remembered it.

I would like also to say, however, a few words specifically about the topic of tax reform, as it is being talked about, and to mention what I mean by effective marginal rates, as opposed to statutory marginal rates.

While the move in the direction of a modified flat tax can be justified on administrative and equity grounds alone, the key considerations are economic growth and efficiency.

There are basically two ways tax reform can stimulate economic growth. First and most important is by increasing the quantity of inputs used in the production process. Any tax reform that encompasses a major reduction in marginal tax rates is likely to do this. Now the precise magnitude of output growth that is obtainable depends on several key variables, such as the elasticity of labor supply, the marginal propensity to save, and so on.

A recent paper by Edgar and Jacqueline Browning suggests that the efficiency gains from a true marginal tax rate reduction, a pure

flat rate tax similar to a Biblical tithe, would be somewhere in excess of $100 billion a year. That is, we could gain $100 billion in annual economic efficiency by going to an absolute flat rate tax. That paper, I understand, is going to be published later in the year in the Cato Journal.

Now, a second way that a simplified tax can improve efficiency and output is through improving the quality of output, specifically through the greater tax neutrality and simplicity associated with eliminating tax preferences.

Investments with relatively low social rates of return are often undertaken because of favorable tax treatment, whereas investments with relatively high social rates of return but unfavorable tax treatment are not undertaken.

The Browning's estimate that this neutrality factor, the elimination of the current lack of neutrality, could provide $15 billion in added efficiency a year, not an inconsequential amount. But the big savings are to come through reductions in effective marginal tax rates.

Base broadening is desirable from the standpoint of improving neutrality and allowing some reduction in the stated marginal rates, but these gains are partly offset by the fact that under these tax reform proposals that we have seen so far, effective marginal tax rates for some types of activity would rise from zero to some higher rate, perhaps 25 or 30 percent.

This is true of activities which are currently sheltered under the law. As a consequence, the rate of return on these activities is reduced and some productive resources will be withdrawn from use in what are now sheltered activities. Thus the growth in productive inputs under a modified flat tax such as Kemp-Kasten or Bradley-Gephardt would be significantly less than it might appear at first, although it would not be zero.

It is useful to make a distinction between two kinds of marginal tax rates: The statutory marginal or maximum marginal rate that is applicable to some forms of income, and the effective marginal rate that is applicable to total income.

Currently, the statutory rate peaks at 50 percent, but the effective marginal rate is less, since a significant portion of income is excluded from the tax base. Using the preliminary 1983 data, I have estimated that the effective marginal tax rate applicable as one moves up the income scale in say the $200,000 to $500,000 range is about 41 percent, well below the statutory rate of 50 percent.

Moreover, since tax preferences are taken in calculating adjusted gross income, that 41-percent figure may overstate the true effective marginal rate. A reduction in effective marginal rates from, say, 41 percent down to 35 percent is significant and important, but is less dramatic than would be, say, a move from 50 percent down to 30 percent or something of that nature.

The sponsors of the major proposals have felt constrained to design their bills so as to not to alter the tax burdens substantially from its present level for any income group, measured in some static sense. In doing so they are attempting to maintain effective marginal rates near the present level. To be sure, there is some such effective tax reduction, such as the Treasury proposal, in most

income brackets, since the bill is not revenue neutral with respect to individual income taxation, since business taxes are effectively raised. But in any case, the reduction in effective tax rates is not dramatic.

I would say there are some proposals on Capitol Hill, such as the one introduced by Senators Symms and DeConcini, that do reduce marginal income rates in various income classes, particularly in the upper brackets. Such legislation has a far greater potential for bringing about significant gains in economic welfare than do the other bills previously mentioned.

While the Symms-DeConcini bill does reduce the tax burden, the analysis of the Browning's suggests that output growth associated with a relatively pure flat tax might offset the increased liabilities facing certain classes of taxpayers. Put differently, there may be no losers but many winners.

The problem with the bills of the Treasury/Kemp-Kasten/Bradley-Gephardt type is that to some considerable extent they rob Peter to pay Paul. They raise marginal rates on some income in order to lower them on other income, so some marginal rates in a sense are not dramatically changed.

That is not to say, however, that I am against these bills. There are some efficiency gains in reducing the nonneutral treatment of different forms of economic activity, and base broadening reduces problems of horizontal inequity, where persons of similar economic circumstances pay widely varying amounts of tax. Also, the tax system would be simpler. Finally, from the standpoint of the underground economy and the tax evasion issue, the relevant tax rate in any discussion is the statutory rate, and the sharp reduction in those rates would lead to significant amounts of activity coming above ground as the benefits of evasion fall relative to the cost.

In a study that I have done relating marginal tax rates to a proxy variable or substitute variable measuring underground economic activity, I observe a very close relationship between statutory marginal rates and tax evasion. This is using data going back to 1914, the first year of the tax. Accordingly, any of the major bills proposed should bring in billions of dollars from the underground. Failure to take that into account—and I might add the various studies done on the various bills have generally failed to take this into account—has been highly unfortunate.

I believe that a further reduction in statutory marginal rates is possible in any revenue-neutral bill. I am not particularly wild about the concept of revenue-neutral bills, but if you are going to adopt it, I think you can lower the rates further without any loss of revenue from current projections. I haven't studied it in great detail, but my hunch is that the rate under the Treasury bill, for example, could be lowered from a 35-percent top rate to a 30-percent rate without any loss in revenue from current projection, just largely through picking up money through the shrinking of the underground economy.

Alternatively, of course, we could modify the Treasury bill in other ways. But in any case, I think getting the marginal rate down is important and possible.

In any case, the evidence from both the immediate and distant past suggests that a relatively radical approach to reform is most

likely to do the most good. Even the less radical bills, however, that are currently in favor, offer some possibility for gains in economic welfare, and thus I welcome their serious discussion. Thank you.

Senator ABDNOR. Thank you, Mr. Vedder.

[The prepared statement of Mr. Vedder, together with an attachment, follows:]

PREPARED STATEMENT OF RICHARD K. VEDDER

THE LAW OF SUPPLY AND TAX REFORM

Four score and 245 days ago, five economists brought forth to this Committee an old notion, conceived in economic theory, and dedicated to the proposition that the amount of economic activity is positively related to its after tax rate of return. Specifically, on June 12 of last year, the Joint Economic Committee was told that the 1981 tax cut led to a major outpouring of productivity activity that enhanced not only economic efficiency but also led to what many Americans would consider to be greater economic justice.

The dramatis personae today is almost the same as last year, as is the message. People respond to incentives. This old notion, embodied in what us economists call the Law of Supply, is perhaps the most clearly empirically verified proposition in economics. For at least two millennia, it has been demonstrated that increases in compensation lead persons to work harder and invest more. It is a notion of classic simplicity, that is readily accepted as common sense by the 99.75 percent of the American population residing outside the District of Columbia. The rediscovery of this notion has historically led to great prosperity, most recently in the revolutionary advances in agricultural output observed in China when reduced confiscatory taxes greatly increased compensation. As far as I can tell, the only three places in the world where the Law of Supply is consistently and emphatically rejected as a matter of economic theology are the Kremlin, the Congressional Budget Office, and the Office of Tax Analysis, U.S. Department of the Treasury.

Briefly reviewing the latest verification of the Law of Supply, a whole host of commentators, including Lowell Gallaway and myself recently in the Wall Street Journal and Tax Notes, have shown that the 1981 tax cut

has rather definitely led to an enormous burst in taxable activity from those groups most advantaged by that tax cut. The 108 percent increase in tax payments from what we have termed "tax millionaires" from 1981 to 1983 cannot be explained in large part by bracket creep, by income shifting strategies, by the vicissitudes of the business cycle, or by changing security markets. As the after tax return of individuals moved from 30 to 50 cents on each additional dollar earned, the burst of new productive activity and the shift of activity from the non-tax to the taxable economy was substantial.

Gallaway and I have shown, moreover, that the dramatic increase in taxable income among rich Americans has been especially concentrated in entrepreneurial activities that directly enhance output; the growth in passive investment income in the form of interest and dividends has been far less than the growth in income from small businesses, partnerships and other forms of entrepreneurship.

One byproduct of this burst in entrepreneurship has been an increase in the proportion of taxes paid by high income Americans. In 1981, those earning $100,000 or more a year paid 17 per cent of the total income tax burden; by 1983, that figure was 20 percent. Part of that rise reflects the normal rise in nominal incomes but even correcting for that, the tax burden shifted toward the rich. The tax Gini coefficent, a measure of the inequality of payments between taxpayers, shifted upward between 1981 and 1983, indicating greater progressivity, in keeping with ability to pay notions of taxation.

In a JEC study published last November, Philippe Watel and I demonstrated that Federal individual income tax revenues from upper income Americans varied inversely with marginal tax rates in the 29 year period 1954 to 1982, even after controlling for growth in nominal income and business cycle fluctuations. This suggests that at the highest marginal rates, the U.S. was

operating in the backward bending portion of the Laffer curve, where the rate reductions so stimulate the growth in the tax base that tax revenues rise. If I may be immodest for a moment, we almost perfectly predicted last November what the 1983 tax revenues from very high income Americans would be.

Despite all this evidence, there are still some commentators who continue to deny that the 1981 tax cut had significant positive economic effects. For example, Jospeh Minarik, writing in the New York Times, rehashed the point that higher tax payments from upper income groups are expected, a normal continuation of a long run trend. He simply ignored the previously mentioned JEC study that details how marginal rate cuts had a positive impact on tax payments from upper income groups that go far beyond the trend effects reflecting nominal income growth. If he thinks the JEC study is flawed, fine, but I challenge him to explain how; to simply ignore that evidence is not particularly responsible, in my judgment.

Minarik also observes that total individual income tax revenues fell after the tax cut, and attributes most of the increased deficit to that factor. Speaking to that point, Table 1 compares expenditures, individual income tax and other revenues for fiscal year 1981, before the tax cut, and fiscal year 1984. It shows clearly that the major single proximate determinant of the rising deficit is increased government spending. To claim that "the 1981 tax cut is the primary reason the deficit is so large" is simply to ignore the factual evidence.

Incidentally, I am sure Dr. Roberts and probably other witnesses would concur in agreeing that even if one accepted the dubious proposition that the tax cut was responsible for the large deficit, there is no evidence that those deficits have had the debilitating effects usually attributed to them. In this regard, Paul Evans has recently demonstrated in an extraordinary paper in the American Economic Review that historical evidence dating back to the Civil

Table 1

The Rising Budget Deficit, 1981-84*

Fiscal Year	Revenues: Ind. Income Tax	Other	Total	Expenditures+ Total	Deficit+ Total
1981	$285.9	$331.4	$599.3	$678.2	$-78.9
1984	296.2	370.3	666.5	851.8	-185.3

Changes, 1981-1984:

Individual Income Tax Receipts	+$10.3
Other Receipts	58.9
Expenditures	+172.4
Change in Expenditures As % of Change in Deficit:	+162.0%
Change in Ind. Income Tax Receipts As %, Change in the Deficit	- 9.7%

*Dollar amounts in billions.

+Includes off-budget items.

SOURCE: Economic Indicators, March 1985

War shows that there has been no relationship between deficits and interest rates in the United States, except quite possibly a negative one. The notion that the tax cut caused deficits which, in turn, caused high interest rates is a notion so contrary to the factual evidence that it is not worth further discussion on my part. Rather, I would prefer to turn to the issue of tax reform.

Pure vs. Modified Flat Taxes

While the move in the direction of a modified flat tax can be justified on administrative and equity grounds alone, the key considerations are the economic growth and efficiency gains obtainable from tax revision. There are basically two ways tax reform could stimulate economic growth. First, and most important, the quantity of inputs used in the production process could rise substantially in any tax reform that encompasses major reductions in marginal tax rates. The precise magnitude of output growth obtainable depends on several key economic parameters, such as the elasticity of labor supply, the marginal propensity to save, etc. In a recent paper, making what I would regard as conservative assumptions, Edgar and Jacquelene Browning estimate that the efficiency gains from true marginal tax rate reductions in an absolutely pure flat tax similar to a Biblical tithe would in the long run reach slightly in excess of $100 billion a year. I stress "long run", since the supply responses are not entirely instantaneous, as the 1981 tax cut has pointed out.

The second way that a simplified tax could improve efficiency and output is through improved quality of output, specifically through the greater tax neutrality and simplicity associated with eliminating tax preferences. Investments with relatively low true social rates of return are often undertaken because of favorable tax treatment, whereas investments with relatively high social rates of return by unfavorable tax treatment are not undertakne. The Brownings estimate these qualitative gains at $15 billion, or 15 percent of the total efficiency gains to be realized from going to a true flat tax.

This is certainly no trivial amount, but the Brownings' estimates suggest that the reduction in marginal rates is far more important than the elimination of tax preferences in terms of promoting long run gains in economic welfare. At the same time, base broadening and rate reduction are interwined, since the expansion of the tax base allows so-called revenue neutral reductions in marginal rates.

While base broadening is desirable from the dual standpoint of improving neutrality and allowing some reduction in stated marginal rates, these gains are partly offset by the fact that under tax reform proposals the effective marginal tax rates for some types of activity would rise from zero to some higher rate, perhaps 25 percent; this is true of activities which are currently sheltered. As a consequence, the rate of return on these activities is reduced; some productive resources will accordingly be withdrawn from use. Thus the growth in productive inputs under a modified flat tax such as Kemp-Kasten or Bradley-Gephardt would be significantly less than it might appear at first.

It is useful to make a distinction between two kinds of marginal tax rates - the statutory or maximum marginal rate that is applicable to some forms of income, and the effective or average marginal rate that is applicable to total income. Currently, the statutory marginal rate peaks at 50 percent, but the effective marginal rate is ... less, since a significant portion of income is excluded from the tax base. Using the preliminary 1983 data, I have estimated that the effective marginal tax rate applicable as one moves from an adjusted gross income in the $200-$500,000 range to an income in the $500,000- $1 million range is 41 percent, well below the statutory rate of 50 percent. Moreover, since tax preferences are taken in calculating adjusted gross income, the 41 percent figure may well overstate the true effective marginal rate. A reduction in effective marginal rates from, say 41 percent to 35 percent is still significant, but far less dramatic than a shift from 50 to 35 percent.

Turning to current modified flat rate proposals, the sponsors of the major proposals have felt constrained to design their bills so as not to alter the tax burden substantially from its present level in any income group. In doing so, they in effect are attempting to maintain effective marginal rates near present levels. To be sure, there is some such effective rate reduction, such as in the Treasury proposal for most income brackets, since the bill is not revenue neutral with respect to individual income taxation, since business taxes are effectively raised. But in any case, the reduction in effective tax rates is not dramatic.

One proposal, the Hall-Rabushka scheme incorporated in legislation introduced by Sens. Symms and DeConcini, does sharply reduce effective marginal rates for various income classes, particularly in the upper income brackets. Such legislation has a far greater potential for bringing about significant gains in economic welfare than the other major bills mentioned. While the Symms-DeConcini bill does involve some redistribution of the tax burden when looked at in a static sense, the analysis of the Brownings suggests that the output growth associated with a relatively pure flat rate approach might offset the increased liabilities facing certain classes of taxpayers. In other words, there may be no losers but many winners.

The problem with the bills of the Treasury/Kemp-Kasten/ Bradley-Gephardt types is that to a considerable extent they rob Peter to pay Paul; they raise marginal tax rates on some income (currently sheltered) in order to lower marginal rates on other income, so effective marginal rates in some ultimate sense are not dramatically changed. This is not to say I am against these bills. There are some efficiency gains in reducing the non-neutral treatment of different forms of economic activity, and base broadening reduces very real problems of horizontal inequity, where persons in similar economic circumstances pay widely varying amounts of tax. Also, the tax system would be simplier. Finally, from the standpoint of the underground economy, the relevant tax rate is the

statutory rate, and the sharp reduction in those rates would lead to significant amounts of activity coming above ground as the benefits of evasion fall relative to the costs. In a study relating marginal tax rates to a proxy variable measuring underground activity, I observed a very close relationship between statutory marginal rates and tax evasion. Accordingly, any of the major bills proposed should bring in billions of dollars from underground. Failure to take that factor into account in revenue projections has been unfortunate, and I believe a further reduction in statutory marginal rates is possible in a revenue neutral bill. While I have not studied it in detail, my hunch is that a 30 percent top statutory rate in the Treasury proposal is probably approximately equivalent to a truly revenue neutral approach. Alternatively, the Treasury bill could be modified to lower the proposed corporate income tax rate, or to exclude more savings from the tax base. The exclusion of savings from the base is a great plus of the cash flow approach incorporated in legislation introduced by Senator Roth, as well as in the Symms-DeConcini bill.

In any case, the evidence from both the immediate and distant past suggest that a relatively radical approach to reform is most likely to do the most good. Even the less radical bills currently in favor, however, offer some possibility for gains in economic welfare.

Wall Street Journal 3/21/85

Soaking the Rich Through Tax Cuts

By Richard Vedder
And Lowell Gallaway

Almost a year ago, the release of Internal Revenue Service data on 1982 income-tax returns showed that higher-income Americans paid more in income taxes in 1982 than in 1981, whereas lower- and middle-income Americans paid less. The preliminary IRS data for 1983 tax returns are in, and repeat the pattern of the 1982 returns. Upper-income earners *are* paying a greater share of the tax burden after the Reagan tax-rate cuts.

A year ago, this interpretation was still open to question by critics and skeptics, while supply-siders proclaimed that since the top income-tax rate fell from 70% to 50% in 1982, the 1982 IRS data showed the tax cut was working just as they said it would. The incentives for higher-income Americans to engage in tax avoidance and even tax evasion were reduced and they responded accordingly. The fact that the number of returns from citizens with an adjusted gross income (AGI) of more than $1 million grew by nearly 60% amid the greatest recession in years was ample evidence that the tax cuts were working.

Various Arguments

All of this, of course, was mildly embarrassing to Democratic presidential hopefuls who were spending most of last year trashing the Reagan administration for its tax policies that supposedly benefited the rich and hurt the poor. However, a horde of commentators rose to their defense and attacked the supply-side view. They argued that the 1982 data were not typical. John Berry of the Washington Post suggested that the stock-market boom explained the rising affluence (and tax payments) of the rich, somehow assuming that the tax-rate reductions had no bearing on that boom. Joseph Minarik of the Urban Institute argued that because of inflationary "bracket creep," the payments from the rich typically rose and the 1982 results merely reflected a long-term trend.

Still others used different arguments. Donald Kiefer, a researcher for the Congressional Research Service, claimed that the wealthy, anticipating the tax-rate reductions, engaged in income-shifting tactics in late 1981 that swelled 1982 taxable income. Finally, some people maintained that because of rising nominal income, the definition of "rich" and "[illegible]" was changing, meaning that a simp[illegible]alysis of the data by constant-income classes led to distorted findings.

While supply-siders believe the bulk of these criticisms to be misdirected or exaggerated, the fact remains that conclusions were being drawn on the basis of a single year's observations. As Mr. Vedder said in a Joint Economic Committee study published last November, ". . . the final word will be the 1983 data."

Well, the preliminary 1983 IRS data are in and they further support the contention that as after-tax rates of return rise the supply of labor and capital also increases. As the first table indicates, affluent Americans (say, those with an AGI of more than $100,000) paid substantially more than in 1981. Poor and middle-income Americans (those making under $50,000 AGI) paid less in 1983 than in 1982, and far less than in 1981. While tax payments rose 28% from 1981 to 1983 for the affluent group, they decreased nearly 12% for the low- and middle-income groups.

The increase in payments from the super rich was particularly dramatic—those with an AGI of $1 million or more paid 108% more in 1983 than in 1981, and the number of "tax millionaires" more than doubled in the greatest explosion of millionaires in U.S. history.

These results are not surprising. In the aforementioned JEC study, an analysis of 20 years of tax data from 1954 to 1982 revealed that upper-income Americans have been highly sensitive to variations in marginal tax rates on both ordinary and capital-gains type income. The study revealed that some Americans were in the backward-bending portion of the Laffer Curve—where reductions in tax rates so stimulate growth in the tax base that total tax receipts from the group rise. Profs. James Gwartney of Florida State University, Richard Stroup of Montana State University and James Long of Auburn University have reached virtually identical conclusions using quite a different methodology and different data sources.

The rise in tax payments reflected mainly a boom in what might be termed "entrepreneurial" income—income from small businesses, partnerships, farms, etc., or from working. The second table indicates that passive or *rentier* income, in the form of dividends, interest, royalties and the like, grew far less rapidly. It would appear that a big surge in entrepreneurial activity has occurred in response to the increase in the part of income that individuals keep after taxation.

The one argument of the critics that has not been addressed is the notion that rising nominal income normally pushes more Americans into higher tax brackets, increasing the pool of persons with incomes in excess of a given amount. One way to deal with this argument is to look at the relative income of Americans, that is, to examine, say, the top 10% of income recipients, regardless of what their income may be. Analysis using this procedure indicates that the shift in tax payments toward the rich is somewhat less dramatic than shown in the first table, but it is occurring nonetheless. The share of total income taxes paid by the top 1% of income recipients grew from 17.44% to 20.64% between 1981 and 1983, with the share of middle-income groups showing a noticeable decline.

A single index of progressivity is the "tax Gini coefficient." A value of 1 indicates perfect progressivity—one rich person pays all the taxes—while a value of 0 describes a situation in which everybody pays the same absolute tax, regardless of income. The tax Gini rose from .6488 to .6560 between 1981 and 1983, a move in the direction of greater progressivity. In other words, the 1981 tax cut seems to have been successful in promoting a key part of the liberal agenda of the past half-century, namely, "redistributive justice."

All of this, of course, speaks to the great tax debate beginning now in Washington. The Treasury, Kemp-Kasten and Bradley-Gephardt proposals all continue in the spirit of the 1981 legislation, further reducing marginal tax rates, raising the rate of return on investment in both human and physical capital, and stimulating growth, fairness and administrative simplicity in the tax system. The evidence from the period 1981 to 1983 indicates that these initiatives also hold the promise of making a welcome addition to the U.S.'s long-term economic vitality.

Mr. Vedder and Mr. Gallaway are professors of economics at Ohio University in Athens, Ohio. They previously served as staff economists with the Joint Economic Committee of Congress.

Table I

Tax Payments By Income Groups, 1981 to 1983

Income Class+	Taxes Paid:* 1981	1982	1983	% of Total Taxes Paid: 1981	1982	1983
$0-$15,000	$26,871	$23,949	$21,027	9.1%	8.4%	7.4%
$15,000-$30,000	80,479	74,196	67,000	27.6	26.0	23.6
$30,000-$50,000	88,222	86,363	84,726	30.3	30.2	29.8
$50,000-$100,000	52,164	51,732	55,151	17.9	18.1	19.4
Over $100,000	43,633	49,267	55,781	15.0	17.3	19.6
Over $1,000,000	4,901	6,965	10,231	1.7	5.4	3.6

*In millions of dollars, refers to total tax liability.
+Adjusted gross income

Source: Internal Revenue Service

Table II

Changing Income of the "Very Rich," 1981 and 1983*

Income Source	AGI Reported:+ 1981	1983	% of Total AGI: 1981	1983
"Rentier" Income#	$4,509	$7,147	40.5%	28.3%
"Entrepreneurial Income"## Total	6,630	18,183	59.5	71.8
Business##	229	4,012	3.0	15.8
Financial###	4,109	8,718	36.9	34.4
Human Capital++	2,186	5,452	19.6	21.5
Total Income	11,139	25,329		

+In millions of dollars.
*"Very Rich" is Defined to Include Returns with an AGI of over $1,000,000.
#Dividends, Interest, Rent, Royalty Income, and Estate and Trust Income.
##All income other than "rentier" income as defined above, see below for specific sources.
###Small Business Corporations, Farms, Partnerships, and Business and Professional income.
###Primarily capital gains.
++Wages and salaries.

Source: IRS data, author's estimates

Senator ABDNOR. Now we will hear from Mr. Roberts.

STATEMENT OF PAUL CRAIG ROBERTS, WILLIAM E. SIMON PROFESSOR OF POLITICAL ECONOMY, CENTER FOR STRATEGIC AND INTERNATIONAL STUDIES, GEORGETOWN UNIVERSITY, WASHINGTON, DC

Mr. ROBERTS. Thank you, Senator. If the Internal Revenue Service's statistics can be believed, the so-called rich are now paying a larger share of the tax burden than prior to the 1981 tax rate deduction. Whether this is because of, or in spite of, the 1981 tax rate reduction, it denies a factual basis to the argument that the Reagan administration's tax policy favored the rich. Nevertheless, I am sure that we will continue to hear this argument from certain quarters.

I am pleased to see this evidence that the Laffer curve works when high marginal tax rates on upper income taxpayers are reduced. It is what my colleagues and I in the Treasury expected. I would caution you, however, that this limited Laffer curve effect is only incidental to the purposes of the 1981 Tax Act. We did not regard the 1981 tax legislation as a punitive measure aimed at making the rich pay more. We were not trying to raise tax revenues for the Government as a share of GNP, and we did not expect revenue increases from middle and lower brackets. We thought less revenues would be lost than predicted by static analysis, but we did not expect to recover all revenues. That is why we defined our budget goal in terms of reducing Federal spending to 19.3 percent of the gross national product by 1984.

It would be most unfortunate if a Laffer curve response, or making the rich pay more, became the arbiter of successful tax policy. As an architect of the 1981 tax reduction, it is perhaps useful if I review for you some of the purposes and aims of the 1981 tax legislation.

If you will remember, by the end of the last decade, economists and policymakers had talked themselves into the position that the economy could not grow without rising inflation. Furthermore, these so-called Phillips curve tradeoffs were getting worse and worse. "Stagflation" and "economic malaise" were the most often used terms to describe the once fabled American economy. By the end of the decade the once mighty dollar had collapsed in foreign exchange markets to its historic low, having lost most of its value against the Swiss franc and the German mark.

An important source of these problems was demand management economic policy, which had pumped up demand while reducing the incentives to produce. This policy contributed to the sharp decline in the growth of the capital-labor ratio and U.S. productivity. American labor and products became less competitive in markets at home and abroad, and large deficits appeared in the U.S. merchandise trade balance for the first time in the postwar period—despite a weakening dollar. Inflation and unemployment rates rose over the decade.

Reagan's economic program was designed to alter this pessimistic outlook and fundamentally improve the prospects for the U.S. economy. The 1981 tax reduction was designed to raise the after-

tax return on real investment in the United States, to improve the incentive to supply labor and human capital, to reduce the tax bias against savings due to the multiple taxation of income from saving and investment rate, and to lower the cost of production.

This sensible and carefully prepared policy suffered from lack of full support from the Republican party and the administration itself. Consequently, its opponents were able to portray it as an attempt to pump up the economy with consumer demand that would be inflationary. The inflation hysteria crowded out the Treasury's warnings in 1981 of the approaching recession. The recession and the unexpected collapse in the inflation rate far below even the Reagan administration's rosy forecast resulted in very large budget deficits, which have been used as weapons against the 1981 tax reduction. Beginning in 1982, taxes have been raised several times—without, I might add, reducing the deficit—and the periodic push for higher taxes hovers over the economy like a black cloud. Senator Abdnor, I request that the article I wrote in Business Week on the failure of the various deficit reduction packages to reduce the deficit be included in the record.

Senator ABDNOR. Without objection, it will be placed in the hearing record at this point.

[The article follows:]

STOCKMAN'S NUMBERS DON'T ADD UP

BY PAUL CRAIG ROBERTS

Tax increases and spending cuts have failed to reduce the deficit. Maybe Stockman's strategy isn't the answer

Even though the Reagan Administration has carried out several large deficit-reduction programs, the budget deficit is larger than ever. This extraordinary fact has failed to arouse much curiosity. Not even the politicians have asked the budget director to explain why the deficit keeps growing in the face of tax increases, spending cuts, and a scaled-back defense buildup.

The Reagan Administration implemented its first deficit-reduction package early in 1981, when the deficit was only $50 billion. At that time, Budget Director David A. Stockman convinced President Reagan that the budget could be balanced by 1984, if personal income tax rates could be cut by 25% instead of 30% and the cuts delayed until the second half of the Presidential term. Stockman got his way. Consequently, fiscal policy did not provide any stimulus to offset the Federal Reserve Board's tight monetary policy in 1981-82. The economy fell into recession, and the deficit estimate jumped from $53 billion to $137 billion.

ROSE GARDEN ROMANCE. The Administration responded to the fiasco of its first deficit-reduction program with a second deficit-reduction program. This time, Stockman assigned to President Reagan the task of wooing House Speaker Tip O'Neill in the White House Rose Garden to help secure passage of the Tax Equity & Fiscal Responsibility Act of 1982 (TEFRA), a tax increase of $229 billion. Stockman's figures showed that TEFRA would reduce the budget deficit from $137 billion in 1983 to only $59 billion in 1987.

Reagan made the case for "revenue enhancement" on national TV and got Congress to pass the tax increase in August, 1982, one year after he had signed the tax cut. The deficit, however, did not go down. By December, 1982, the 1983 deficit had ballooned overnight from $137 billion to $223 billion. Stockman's revised projection for 1987 showed a deficit of $280 billion, a fivefold increase in four months.

Despite further tax increases—higher gasoline taxes and increased Social Security taxes as a result of the recommendations of the National Committee on Social Security Reform—the budget deficit continued to grow. By January, 1983, the Administration was predicting future deficits of $300 billion.

By mid-1983 the unexpectedly strong economic recovery forced Stockman to reduce his astronomical $1.424 trillion five-year deficit projection by 25%. But the deficit was still too large, and in mid-1984 another deficit-reduction package, the "Rose Garden downpayment plan," passed Congress. The *Midsession Review of the 1985 Budget*, which was released by the Office of Management & Budget on Aug. 15, 1984, reported that the deficit downpayment had reduced the 1985 deficit by $34 billion, the 1986 deficit by $58 billion, and the 1987 deficit by $68 billion. As of August, 1984, these savings had reduced the 1985, 1986, and 1987 deficit projections to $172 billion, $174 billion, and $185 billion.

But once again the deficit went up instead of down. In spite of the mid-1984 downpayment on the deficit, by January, 1985, Stockman's deficit projections for 1985, 1986, and 1987 had jumped to $224 billion, $230 billion, and $246 billion.

Something is going on that doesn't meet the eye when, during a six-month period following enactment of a $158 billion deficit-reduction program, the three-year budget projection increases by $170 billion. During this short period when the deficit projection grew by one-third, no tax cut was enacted, spending did not explode, and the economy did not shake loose from its moorings.

The situation becomes even more inexplicable when the 1982 and 1984 deficit-reduction packages are combined. For example, the two programs together were supposed to reduce the 1987 deficit by $137 billion. Yet Stockman's latest projections show a 1987 deficit of $246 billion—an increase of $61 billion since last August.

NO CONTROL. Something is wrong when the deficit continues to grow despite an unexpectedly strong economy and the passage of major deficit-reduction legislation. Either the budget director's numbers are meaningless, or conventional thinking about how to reduce the deficit is at odds with reality.

Now in its fifth year, the Reagan Administration has yet to establish any control over the number-crunching that determines the policy outlook. Stockman retains his media reputation as a whiz kid with numbers, despite his deplorable performance and lack of any prior professional training or experience. The same lack of experience and policy knowledge appears in the Treasury Dept., where most appointed officials do not have the ability to judge the revenue projections handed to them by bureaucrats in the Office of Tax Policy. Normally, an Administration that cannot control the numbers cannot control the policy. It is amazing that the Reagan Administration, despite its messy act with the numbers, has nevertheless managed to head economic policy in a supply-side direction. If Reagan can keep policy steered that way, the doomsayers who have been predicting economic disaster for the past five years may eventually change their minds. ■

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Mr. ROBERTS. As we all know the best-laid plans of mice and men often go astray. Nevertheless, despite the many things that have worked to undermine the success of the 1981 tax legislation, the policy achieved its goals. We have experienced 2 years of strong real economic growth and declining inflation—something that has not happened for two decades. According to the official statistics of the U.S. Government, as duly reported in the Economic Report of the President, we have had an investment-led recovery, during which investment increased much more rapidly than in prior recoveries. Gross private savings as a share of GNP is up 2 percentage points or about 12 percent. This is the result of the accelerated capital cost recovery system, which substantially increased business cash flow or business saving.

We do not yet know whether the 1981 tax cut will duplicate the effect of the 1964 tax cut in raising the real personal saving rate. The effects of severe recession, when many people are forced to dissave, and robust recovery, when many people make deferred purchases, offset the effect of a lower marginal tax rate on the personal saving rate. If the economy experiences a more normal period before the effects of the 1981 tax reduction are eroded, we might expect to see a rise in the personal savings rate.

After declining steadily for a decade, the dollar also recovered. Indeed, it recovered so much so fast that some people are trying to turn its recovery into a crisis. Senator Abdnor, all too often these days the facts play no role in the policy discussion. I request that an article I wrote in Business Week on the dollar's recovery be included in the record.

Senator ABDNOR. Without objection, it will be placed in the hearing record at this point.

[The article follows:]

THE STRONG DOLLAR: A SHEEP IN WOLF'S CLOTHING

BY PAUL CRAIG ROBERTS

The currency's clout just isn't the problem that Volcker and foreign heads of state have claimed it to be. But the Fed's recent intervention in foreign exchange markets could spur a crisis of its own

In February the Reagan Administration departed from its policy of nonintervention in foreign exchange markets to smooth the visit of British Prime Minister Margaret Thatcher to the U.S. This was a mistake because there is no merit to Thatcher's claim that the U.S. budget deficit is a magnet for foreign capital. U.S. intervention only encourages allies to continue to mismanage their economies. The ultimate consequences could be far worse than ruffled diplomatic feathers.

The dollar is strong today compared with its historic lows of 1978-80 for fundamental reasons. The decade of the 1970s was a period of rising U.S. inflation, rising taxes, and declining confidence abroad in the U.S., as one President was driven from office and another vacillated endlessly. The dollar reflected the deterioration in the economic and political environment, and it declined 62% in relation to the Swiss franc and 54% in terms of the West German mark.

BROKEN SHIELD. Despite a weakening dollar, deficits appeared in the U.S. merchandise trade balance for the first time in the postwar period. In 1977, as the dollar began its final fall, the trade deficit jumped sharply to $31 billion, where it more or less remained until 1983. Obviously, U.S. problems of competitiveness predate the "strong dollar" of today. During the 1970s, the U.S. experienced a collapse in the growth of the capital-labor ratio and labor productivity. As a result, high-priced U.S. labor was no longer shielded from foreign competition by strong productivity growth.

Today the fundamentals are radically different from the 1970s. Inflation is way down, and surveys show that inflation expectations continue to fall. The 1981 tax reduction improved the aftertax rate of return on real investment in the U.S., and productivity experts believe the U.S. will continue to experience improved productivity growth during the 1980s. The dollar's recovery is simply a corollary of the fundamental recovery in the economy.

Unfortunately, Federal Reserve Board Chairman Paul A. Volcker and European heads of state are turning the dollar's recovery into a crisis. In his Feb. 20 testimony before the Senate Banking Committee, Volcker continued to ignore the facts and to associate the dollar's strength with large federal budget deficits, high interest rates, and a record external trade imbalance financed by the alleged inflow of "an enormous amount of savings from abroad." The stability of our capital and money markets, Volcker declared, "is now dependent as never before on the willingness of foreigners to continue to place growing amounts of money in our markets." With London's *Financial Times* and other foreign press taking their cue from Volcker, the dollar's recovery has been turned into the latest crisis engineered by the Reagan tax cut.

DANGEROUS NONSENSE. Just as Volcker sees the dollar's strength as a bubble that endangers U.S. financial stability, Europeans see it as threatening their recovery by sucking capital out of Europe. This is both ignorant and dangerous nonsense. It is ignorant because U.S. government statistics show that the U.S. is financing its own balance-of-trade deficit by sharply curtailing its capital outflows. When in 1983, with the U.S. recovering, the merchandise trade deficit jumped from the roughly $30 billion level of the previous six years to $61 billion, U.S. capital outflows collapsed from $119 billion in 1982 to $49 billion in 1983, an amount more than enough to finance the increased deficit. During 1984 (based on three quarters at an annual rate), U.S. capital outflows fell to less than $10 billion.

Far from drawing ever more capital in from abroad, during 1983 when the U.S. trade deficit doubled, foreign-owned capital inflows fell by $13 billion—from $95 billion in 1982 to $82 billion in 1983. In 1984, when the U.S. trade deficits again rose substantially, capital inflows continued at their 1983 level.

The "dollar crisis" is dangerous nonsense because it engenders economic policies abroad that prevent the normal economic adjustment process. Ordinarily the U.S. trade deficit would stimulate European economies—the so-called locomotive effect—and the U.S.'s successful progrowth tax policies would be emulated abroad. Instead, both Britain and West Germany raised their interest rates, endangering their recoveries and reducing the markets for U.S. exports.

Contrary to expectations, if the U.S. budget deficit is reduced the dollar will strengthen as the U.S. outlook further improves. The view that the dollar's recovery is a crisis is a form of "doublethink" that justifies harmful economic policies because they weaken the dollar. For example, a tax increase that wrecked the U.S. investment climate or renewed inflation would certainly weaken the dollar and halt the flow of imports into the U.S. that allows Latin Americans to service their debts and Europeans to grow out of their doldrums.

Exchange market intervention is pointless. If the Fed believes that it is not meeting the world demand for dollars, it can slow the dollar's rise by permitting faster money growth at home. ■

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Mr. ROBERTS. If President Reagan's tax policy had had the full support of the Government, his party, and the Federal Reserve Board, the economic restoration that has occurred would today be on firmer footing. The lack of full support has allowed the President's opponents to cloud the success of his policy and to keep the door open for tax increases. Some people have been making more grandiose predictions about the economic benefits of raising taxes than Art Laffer made for lowering taxes.

If I had to sum up the purpose of the 1981 tax reduction in a single goal, I would say it was to increase U.S. productivity growth. U.S. labor is relatively high priced. For high-priced labor to compete in world markets, it has to be more productive. This was the case in the 1960's when, despite a strong dollar, the United States was an effective competitor. During the 1970's, U.S. productivity growth consistently fell. Indeed, it feel so much that despite a weakening dollar we became less competitive. The key to our future and that of the Western alliance is U.S. productivity growth. The key to productivity growth is tax policy.

We cannot afford a tax policy that has negative effects on work attitudes and the investment rate. With our domestic industries facing the competitive discipline of world market prices, domestic tax changes that raise the cost of production will cause severe shrinkage of the affected domestic industries. This is not generally appreciated by many of the people who are proposing tax reforms. There are many features in most of the tax reform proposals that would reduce U.S. competitiveness in world markets and increase protectionist pressures.

Let me leave you with a concrete example of one recent tax law change that appeared reasonable on the surface but had a devastating impact on a major American industry.

Recently Paul A. Volcker, the Chairman of the Federal Reserve Board, expressed his concern that important sectors of the U.S. economy, such as mining, are being left out of the recovery. Volcker blames the Federal budget deficit as the cause of this economic imbalance, but in fact the industry owes its hard times to a deficit reduction package known as the Tax Equity and Fiscal Responsibility Act of 1982 [TEFRA].

The centerpiece of TEFRA was a corporate minimum tax designed to ensure that every profitable corporation pay some tax. The tax applied a 15-percent surcharge to an arbitrary selection of allowable tax reductions. Mineral exploration and development costs was one of the new items subject to the minimum tax.

The minimum tax is an add-on tax that raises production costs and forces adjustments to be made to reduce the scale of operation. In the case of mining, TEFRA added 3.6 cents in cost to each $1 of output sold. In 1980, the average after-tax profit of each $1 of mining sales was only 5.7 cents. The profit rate was higher on the lowest cost operations and lower on highest cost operations. The minimum tax wiped out 63 percent of the profits necessary to maintain the 1981 level of mining activity. The industry began shrinking immediately upon announcement of the new tax, shedding marginal operations and retaining only those which were still profitable after the add-on tax. As the chart at the end of my oral statement shows, the minimum tax caused a decline in mining pro-

duction that was much more severe than the drop in manufacturing that was caused by the recession.

The proponents of the minimum tax estimated that it would raise $4.4 billion over 6 years as part of the $238 billion TEFRA package. This estimate relied on the standard static revenue method. An ex-post examination of the revenue change from this provision makes clear that the minimum tax was a revenue loser. Capacity utilization figures from the Federal Reserve confirm that mining activity has fallen substantially from previous levels. The decline in activity translates into $30 billion of lost labor compensation over the 6-year period.

The lower labor income means a $4.2 billion reduction in Social Security taxes and $3.5 billion less in Federal income taxes. The human costs are also great—about 180,000 mining jobs were lost. The normal estimate is that two support workers are displaced for each primary worker that loses his job. When the lost revenues from displaced support workers are included, the overall effect of the minimum tax will be to increase the deficit by $23 billion rather than to reduce it by $4 billion. Perhaps this is one reason why the deficit goes up each time Congress passes a deficit reduction package. Regardless, it is doubtful that the 540,000 people who lost their jobs as a result of the impact of the 1982 minimum tax on mining are pleased with the greater tax equity and fiscal responsibility that the Government provided in 1982.

Even a cursory glance at the mining market would have revealed to policymakers that the domestic price is substantially determined by the world price and, therefore, that the tax could not be passed on to consumers and would have to be absorbed mainly by shrinkage of the domestic industry. But since policymakers are addicted to static revenue estimates and assume no behavioral response, they looked for none and collapsed the U.S. mining industry.

This result was not anticipated, and it is an indication of the surprises that will result from a major tax reform undertaken by the same people. It is noteworthy that the sharp drop in U.S. mining activity occurred despite the 25-percent reduction in personal tax rates—a result that is at odds with the claim that lower tax rates on individuals will automatically offset the increase in the cost of capital stemming from the loss of accelerated cost recovery, the investment tax credit, and other tax preferences. There is a substantial risk that anything similar to the Treasury's tax reform proposal would reduce the investment rate. It does not do any good to give an individual a tax cut in a way that costs him his job. Whoever got the equity from TEFRA, it was not the miners.

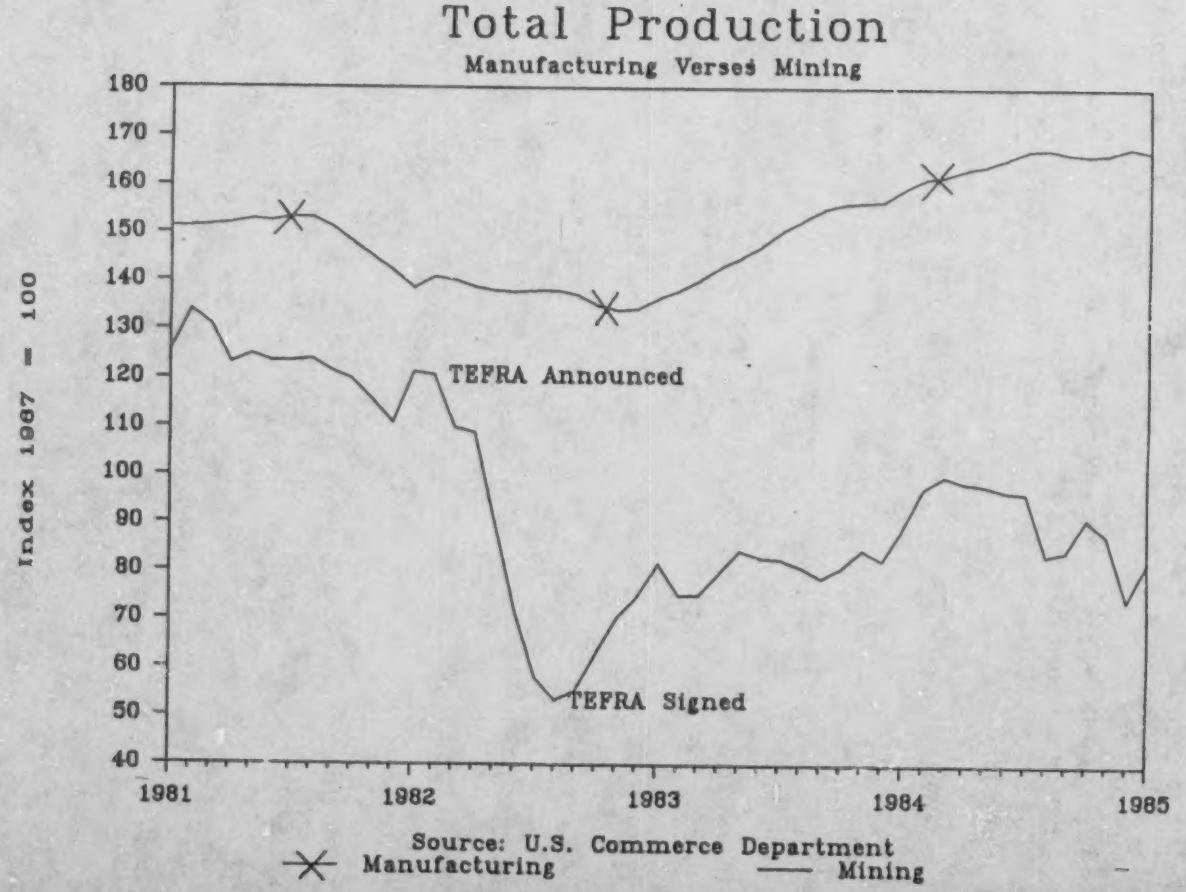
Senator Abdnor, members of the committee, this may sound strange coming from the person who drafted the Kemp-Roth bill, but we must be careful that we don't overblow the success of the personal income tax cuts and imprudently assume, without doing the proper analysis, that lowering tax rates automatically compensates for other things we might do that would raise the cost of capital. It is likely to be the case that far greater reductions in tax rates than are being contemplated are necessary to compensate for the loss of ACRS and the investment tax credit. It is sobering, I think, that the 1982 minimum tax did so much unexpected damage to the mining industry. Very few people have much inkling of the

economic effects of changes in taxation, and these few are not very well represented in the ranks of the present policymakers. I, for one, will be holding my breath that the economy survives the tax reform.

That completes my statement, Senator Abdnor.

Senator ABDNOR. Thank you, Mr. Roberts.

[The chart attached to Mr. Roberts' statement follows:]


Total Production
Manufacturing Verses Mining
Index 1967 = 100
180
170
160
150
140
130
120
110
100
90
80
70
60
50
40
1981
1982
1983
1984
1985
TEFRA Announced
TEFRA Signed
Source: U.S. Commerce Department
Manufacturing
Mining

Senator ABDNOR. Last but not least, Mr. Rahn.

STATEMENT OF RICHARD RAHN, VICE PRESIDENT AND CHIEF ECONOMIST, CHAMRER OF COMMERCE OF THE UNITED STATES

Mr. RAHN. Thank you, Senator Abdnor. I am Richard Rahn, vice president of the Chamber of Commerce of the United States. The chamber is the largest organization of businesses in the world. On behalf of the chamber, I thank you for letting us present our views on the fairness of the 1981 Tax Act. In the interest of time and not to be repetitious, because I fully concur with the comments of my colleagues here, I will briefly share some of my thoughts, and I request my entire prepared statement be made a part of the record.

Senator ABDNOR. It will be made a part of the record.

Mr. RAHN. Despite the howls from the self-proclaimed advocates of the poor, the simple fact has been laid out this morning is that the Reagan administration has increased the tax burden borne by the well-to-do and decreased the taxes paid by the poor. As the supply-siders predicted, the tax rate reductions for taxpayers subject to high marginal tax rates paid for themselves and caused a dramatic improvement in the economy.

The accelerated cost recovery system, ACRS, was a cornerstone of the Economic Recovery Tax Act of 1981. It is clearly working, as Mr. Roberts has pointed out. Replacement of the inadequate asset depreciation range [ADR] system with ACRS cut the cost of capital and allowed businesses to make the investment in plant equipment needed to drive recovery. Business investment has increased 32.4 percent since the fourth quarter of 1982. This is the highest rate of capital formation in any postwar recovery. The average increase during postwar recoveries is 15.9 percent, half of the present rate.

Capital formation did not fall nearly as much during the last recession because of ACRS. Increased capital formation increases productivity, employment, and competitiveness. Because pre-ERTA allowances were insufficient, the U.S. economy has fallen behind, stagnated, and become uncompetitive. Our capital stock was much older than our trading partners because our allowances had been insufficient for decades. Any further cutbacks in ACRS will sabotage the progress made to date.

The tax law has undergone many changes over the past years, often several major changes in 1 year. Businesses have watched tax cuts be enacted only to be undone within a year. This sort of activity makes planning difficult. Moreover, it makes every tax reduction suspect and therefore reduces the efficiency of its incentives.

Many businesses have chosen not to take advantage of the new tax incentives because they expect the new advantages to disappear. They will not make marginal investments on the basis of tax provisions if they expect them to disappear, thus rendering the investments unprofitable.

ACRS under ERTA was simple. The Tax Equity and Fiscal Responsibility Act of 1982, TEFRA, introduced new complexities. The Tax Reform Act of 1984 added amazingly complex new rules. This ever-increasing complexity is rapidly undoing the progress made in 1981.

In both 1978 and 1981, the rate at which capital gains were taxed was dramatically reduced. In 1978, capital gains tax rates were reduced from 49 to 28 percent. The rate reduction led to at least $2.5 billion more Federal revenues and increased the portion of total tax borne by the wealthy. It also led to higher taxes on the wealthy. If we assume, as almost certainly is the case, that those with adjusted gross incomes of over $500,000 are in the maximum tax bracket, then capital gains tax paid by the wealthy was $1.8 billion in 1978 and $4.2 billion in 1981. This constitutes a 130-percent increase in tax revenues.

Even partisans of big government should favor the Reagan, Kennedy, and Mellon tax rate reductions for upper income taxpayers. Those tax cuts raised more money for Government to spend. We have not examined, however, the enormous cost of high tax rates to the broader public. Both those paying taxes and those hoping to have enough income that they must pay taxes, are forced to bear the burden of a stagnant economy. Low rates of economic growth have been thrust on the American economy by those who would rather assuage their conscience by angry rhetoric and misguided attempts to punish the rich when America could have an economy sufficiently dynamic to improve the standard of life for everyone.

The positive incentive effects of the tax cuts continue to unfold. The robust expansion presently under way has unexpected power. What this adds up to is a surprisingly large increase in the tax base. The incentive-based tax cuts have been responsible for an 8-percent increase in tax budget in fiscal year 1984 compared to 1982. In effect, economic growth is increasing Federal revenues at the same time it is decreasing Federal spending.

Congress having failed to reduce Federal spending, some now have cast their eyes upon tax reform to close the deficit. They would translate tax reform into a euphemism for a major tax increase. But where are the tax revenues to come from? Evidence provided by the IRS indicates that it will not come from the rich. Increasing tax revenues on the rich will simply drive them into tax shelters or unproductive economic behavior, thus reducing Federal revenues. The Grace Commission has calculated that even if the IRS confiscated 100 percent of all remaining taxable income above $75,000, it would run the Government for no more than 10 days.

This means that any tax increase will come out of the paychecks of the lower and middle income class taxpayers. This group accounts for 90 percent of all personal income tax payments.

Their 1981 tax cuts have already been whittled away by bracket creep, Social Security tax increases, and higher excise taxes. How much further can we dip into their pocketbooks?

The message should be clear by now. Any major assault on the Federal deficit must be based on cuts in the growth of Federal expenditures. An increase in tax rates would create strong disincentive effects that would eradicate any gains made by reducing the demand for credit by the Federal Government. Furthermore, it would not lead to anything like the increased tax revenues the proponents of tax increases claim. We must admit Federal Government is an extravagant spender and that one does not cure the habits of an extravagant spender by providing him with more funds.

The results of the 1981 tax cut are in. They show these tax cuts have provided strong incentive effects. They have increased the share of taxes paid by the rich by causing them to produce more and to shelter less income. They have been a prime ingredient in the current economic expansion. ACRS has caused a dramatic increase in capital expansion. This proven success should place the focus of deficit reduction on the expenditure side of the ledger. Major tax increases threaten to reverse all the gains that have been made so far.

Thank you very much, Senator Abdnor.

Senator ABDNOR. Thank you, Mr. Rahn.

[The prepared statement of Mr. Rahn follows:]

PREPARED STATEMENT OF RICHARD RAHN

I am Richard Rahn, Vice President and Chief Economist for the Chamber of Commerce of the United States. The Chamber is the largest federation of business and professional organizations in the world. On behalf of the Chamber, I would like to thank you for the opportunity for expressing our views on the fairness of the Economic Recovery Tax Act of 1981 (ERTA).

The Goal of ERTA

ERTA led to at least a 25 percent reduction of marginal tax rates for everyone and about a 7.5 percent reduction in the average person's tax liabilities. Single taxpayers making $41,500 or more and married taxpayers making more than $60,000, however, saw their rates reduced from 70 percent to 50 percent, or about 29%. The details of the tax cut are set forth in Table I.

TABLE I

TAX RATES UNDER ERTA 1981-1984

Taxable Income (000s) (Joint Return)	1980	1981*	1982	1983	1984
0-3,400	0	0	0	0	0
3,400-5,500	14	13	12	11	11
5,500-7,600	16	15	14	13	12
7,600-11,900	18	17	16	15	14
11,900-16,000	21	20	19	17	16

TABLE I (Continued)

TAX RATES UNDER ERTA 1981-1984

Taxable Income (000s) (Joint Return)	1980	1981*	1982	1983	1984
16,000-20,200	24	23	22	19	18
20,200-24,600	28	27	25	23	22
24,600-29,900	32	30	29	26	25
29,900-35,200	37	35	33	30	28
35,200-45,800	43	41	39	35	33
45,800-60,000	49	47	44	40	38
60,000-85,600	54	50	49	48	42
85,600-109,400	59	50	50	48	45
109,400-162,400	64	50	50	50	49
162,400-215,400	68	50	50	50	50
215,400 and above	70	50	50	50	50

*Late in 1981, a 1.25% credit became effective. The chart reflects the tax rate equivalent to the credit.

Proponents of these tax cuts urged that the tax cut would encourage more work, savings and investment and would lure the rich out of tax shelters and into taxable investments. In the long run, the tax cuts, by increasing the return to capital and labor could also lead to robust economic growth, an even greater expansion of the tax base and more economic benefits for everyone.

The marginal tax rate is the rate of tax a taxpayer will pay on the next dollar he earns. A taxpayer's average or effective tax rate, in contrast, is the sum of taxes he pays divided by his total income. The economically more relevant tax rate is the marginal tax rate. When making the economic decision whether to work an extra hour, a taxpayer is concerned with the degree to which the extra income will be taxed. He will not concern himself with how much tax he paid on his first $1,000.

As marginal tax rates increase, so do the disincentive effects of taxation. A tax on work (employment income) makes work less attractive relative to leisure. Many people will choose to work less. In economics jargon, they will substitute towards leisure because the tax raises the price of work relative to leisure.

Similarly, taxes on savings (investment income) raise the price of savings relative to consumption and cause people to substitute towards present consumption. The price of consuming now is the amount of investment income foregone by the consumer (i.e., interest the money spent could have earned if deposited in the bank instead). A tax on investment income reduces the amount of after-tax income foregone and consequently makes present consumption relatively more attractive. Confiscatory rates of tax on investment income, for example, will usually cause consumption of luxury goods to climb. An example will help to explain the reason for this substitution.

Suppose a taxpayer in a 91% tax bracket (which existed in the U.S. for two decades) were contemplating the purchase of a very expensive car. The purchase of a $100,000 automobile would cost its owner $10,000 annually in foregone investment income if interest rates were 10%. After taxes, however, the cost of owning the car would be reduced to $900. The taxpayer would only be foregoing $900 in investment income after the 91% tax was imposed.

The tax would reduce the after-tax price of consumption relative to investment by 91%. The advantage of investing and the cost of consuming would decline dramatically. Consequently, many taxpayers will choose to consume rather than invest. High tax rates, then, reduce savings and investment.

A transactions based tax, such as a sales tax, increases the price to the buyer (reducing demand) and reduces the price to the seller (reducing supply). Since both supply and demand are reduced, total economic output (i.e., the number of transactions) is reduced as well.

In summary, tax rates and the tax base are inversely proportional. The tax base will be its largest if it is not taxed and will virtually disappear if it is subject to tax rates approaching 100%. In other words, higher tax rates cause reduced tax bases.

A necessary corollary of this relationship is that the government will raise progressively smaller amounts of revenue for each incremental tax rate increase. Each additional tax rate increase will accentuate the disincentive to work, save or invest.

What ERTA's Detractors Said

Many doubted the efficacy of these "supply-side" incentives. They maintained that such a drastic cut of marginal rates would have no impact upon the tax base. As a consequence, less taxes would be collected from the rich, and the poor would bear a larger percentage of the tax burden. Some have argued for three years that the tax cut favored the rich and have attempted to sell that notion.

This is a very sensitive issue, and the resolution of the debate will influence the course of economic policy for decades. Examples of the continuing battle over the actual effects of the Reagan tax cuts include a Staff Analysis prepared by the Congressional Budget Office (CBO) and the Urban Institute's study The Reagan Record. The CBO study, entitled The Combined Effects of Federal Taxes and Spending Programs since 1981, was a static estimate of net tax reduction by income class and gave the distinct impression that the tax cuts would actually reduce the share of taxes paid by the rich and increase the poor's share. Some members of the press, ever eager to pounce on the "fairness issue," used the CBO study to attack Reaganomics. The Urban Institute study used static projections based on old data to conclude that Reagan hurt the poor. "Rich gain, the poor lose," read the headlines.

Reagan Tax Cuts Soak the Rich

The results for 1982 and 1983 are now officially in. They show emphatically that incentives do matter. The percentage of taxes paid by the rich has increased while the percent paid by the poor has actually fallen.

Tables II and III below illustrate the supply-side effects of the first year of the tax reductions. Although their tax rates were reduced from 70% to 50%, those earning over $1 million paid 37% more taxes in 1982, a recession year, than 1981. Similarly, those earning between $500,000 and $1 million annually paid 25% more taxes in 1982 than 1981. By 1983, those earning over $1 million were paying 102% more taxes. Those earning between $500 thousand and $1 million paid 47% more.

Equally as fascinating is the fact that the rich paid a larger share of the total tax burden after the Economic Recovery Tax Act than before. ERTA, despite all of the misguided criticism directed toward it, made the tax system more progressive. Between 1981 and 1982, the tax burden of those earning over $1 million increased about 40% (from 1.7% to 2.4% of the total tax burden). The tax burden of those earning between $500,000 and $1 million increased from 1.6% to 2.0%, or 25%. By 1983, each group was bearing almost twice as much of the overall tax burden as they were before ERTA. In fact, only those earning below $50,000 per year actually paid a smaller portion of the total tax burden the first year after ERTA was enacted.

TABLE II

TAXES PAID UNDER ERTA 1981-1983

Net Income Group (000s)	Revenues Collected (000,000s) 1981	1982	1983	Percentage Change 1981-1982	1982-1983	1981-1983
$0-10	$8,588	$7,627	$6,874	-11%	-10%	-20%
10-20	41,038	36,298	33,177	-12	-9	-19

TABLE II (Continued)

TAXES PAID UNDER ERTA 1981-1983

Net Income Group (000s)	Revenues Collected (000,000s) 1981	1982	1983	Percentage Change 1981-1982	1982-1983	1981-1983
20-30	57,101	53,772	47,810	-6	-11	-16
30-50	88,257	86,363	84,776	-2	-2	-4
50-75	37,504	36,807	39,460	-2	7	5
75-100	15,129	14,925	15,720	-1	5	4
100-200	22,142	22,324	22,782	1	2	3
200-500	13,174	14,399	16,129	9	12	22
500-1000	4,579	5,719	6,741	25	18	47
1000 and above	5,05 3	6,94 5	10,23 1	37	47	102
TOTAL	292,256	285,179	282,859	-2	-1	-3

TABLE III

TAX SHARE UNDER ERTA 1981-1983

Net Income Group (000s)	Percentage of Total Tax Burden 1981	1982	1983
0-10	2.9%	2.7%	2.4%
10-20	14.0	12.7	11.7
20-30	19.5	18.9	16.6
30-50	30.2	30.1	29.9
50-75	12.8	12.9	13.9
75-100	5.2	5.2	5.5
100-200	7.6	7.8	8.0
200-500	4.5	5.0	5.7
500-1000	1.6	2.0	2.4
1000 and above	1.7	2.4	3.6
TOTAL	100.0	100.0	100.0

These statistics came under sustained attack from liberal economists who scurried to explain them away as reflecting only the strong stockmarket or "gaming" of the tax system by wealthy taxpayers. Gaming is a term used to describe taxpayers' decisions, for example, to realize capital gains in 1982 rather than 1981 since 1982 tax rates were reduced.

The most recent statistics belie the gaming thesis. Gaming is a one year phenomenon that necessarily reduces the following year's taxable income (1982 in this case). The share of the overall tax burden paid by the wealthy has continued to increase in 1983.

Despite the howls of righteous indignation from the self-proclaimed advocates for the poor, the simple facts illustrate that the Reagan tax program has increased the burden borne by the well-to-do and reduced the proportion of the republic's taxes paid by the poor.

As the supply-siders predicted, the tax rate reductions for taxpayers subject to high marginal tax rates paid for themselves and caused a dramatic improvement in the economy. The tables make it clear, however, that the government lost revenue from those taxpayers earning less than $50,000.

The pattern is clear. If one wants to truly "soak the rich," the way to do it is to reduce high marginal tax rates. Some of the most able ministers of public finance, cognizant of the disincentive effects of taxation, have employed this tactic to boost both economic growth and tax revenues. In the nineteenth century, William Gladstone of England often employed the simile that imposing high taxes on the rich was like killing the goose that laid the golden egg. His tax cuts were an important ingredient in the booming economic growth of the British Empire during the middle and late nineteenth century. Andrew Mellon, Secretary of the U.S. Treasury during the 1920s, used the same policies to boost taxes paid by the rich. He argued, "Is it fair to tax the rich at a very high rate and collect a paltry amount or tax them at a lower rate but get more money?"

The Failure of Static Economics

History seems easily neglected when it comes to examining the actual effects of the Reagan tax program. Although it contained merely a static estimate, the CBO analysis, for example, was used as a basis for prediction, by others. The CBO simply "projected" tax shares by multiplying the previous tax base with a lower tax rate. This static arithmetical exercise would

obviously lead to a smaller share paid by the upper income groups since the tax cuts were initially greater for this group. The CBO exercise was inexcusably misleading because it employed static revenue estimates in a March, 1984 report even though actual results were available in January 1984.

Actual results for future years will almost certainly show even greater taxes collected from higher income taxpayers, not less. Whereas many interpreted the CBO study to mean that the rich will be paying less in taxes in response to a cut in marginal tax rates, the available data indicate just the opposite. When one considers actual results, supply-side economics is alive and well.

A legitimate concern is whether the wealthy paid increased taxes simply due to bracket creep. Are the rich simply paying more because this group is becoming larger through bracket creep? Probably not.

1982 and 1983 was a year of low inflation; the Consumer Price Index (CPI) increased by only 3.9 percent in 1982 and 3.8 percent in 1983. Consequently, not much bracket creep occurred. Furthermore, the percentage of taxes paid by the rich has increased only in those years where they have received significant tax rate decreases. From 1973 to 1983, the most important bracket creep years, the sharpest rise in the percentage of taxes paid by the rich occurred only in those years which coincided with tax reduction. For example, the effective maximum rate on capital gains above $50,000 fell from 49 percent to 28 percent in 1978, then to 20 percent in 1981. Over this same period we experienced a significant increase in the percentage of taxes paid by the rich, the sole group for whom capital gains are an important source of income.

Earlier Supply-Side Experiments

Skeptics continue, despite the evidence, to attack ERTA as being both unfair and a "massive revenue drain." Most disappointing is the fact that simple denial of the record continues to be received as reasoned argument in the media. If one is willing to look objectively at the facts, ERTA has been an unqualified success. It has been "fair" -- if that means that the wealthy are paying more. It provided a 25% across-the-board tax cut but only reduced individual income tax revenues by 3% (and the revenue loss is decelerating). And finally, it has reduced the disincentives to work, save and invest so dramatically that the economy has grown at almost unequaled rates.

Proponents of reduced tax rates are not limited to arguing the merits of ERTA, however. Other equally compelling evidence exists to prove the thesis that high marginal tax rates have a devastating effect on the economy and can become literally counterproductive. The Kennedy tax cuts of 1963 to 1965 tell the same story. So do the Mellon tax cuts during the 1920s. Finally, the facts surrounding the reduction in the rate at which capital gains are taxed illustrate that reduced tax rates often literally increase tax revenues. Table IV compares marginal tax rates under the 1954 Internal Revenue Code, under the Kennedy proposal and as enacted by the 1964 act.

TABLE IV

TAX RATES 1954-1964

Taxable Income ($ 000) (Joint Return)	1954 Act	Kennedy Proposal	1964 Act
0-1	20	14	14
1-2	20	14	15
2-3	20	16	16
3-4	20	16	17
4-8	22	18	19
8-12	26	21	22

TABLE IV (Continued)

TAX RATES 1954-1964

Taxable Income ($ 000) (Joint Return)	1954 Act	Kennedy Proposal	1964 Act
12-16	30	24	25
16-20	34	27	28
20-24	38	30	32
24-28	43	34	36
28-32	47	37	39
32-36	50	40	42
36-40	53	42	45
40-44	56	45	48
44-52	59	47	50
52-64	62	50	53
64-76	65	52	55
76-88	69	55	58
88-100	72	57	60
100-120	75	58	62
120-140	78	59	64
140-160	81	60	66
160-180	84	61	68
180-200	87	62	69
200-300	89	63	70
300-400	90	64	70
400 and above	91	65	70

In January, 1963, President Kennedy proposed reducing individual marginal income tax rates from the 20-91% range that had prevailed since 1946 to 14-65%. In addition, Kennedy proposed reducing the corporate tax rate from 52% to 47%. In February, 1964, the Congress enacted the Revenue Act of 1964 which reduced rates to 14-70%.

These marginal tax rate reductions caused total federal individual income tax revenues to increase and made the tax system more progressive. Those earning over $1 million paid 147% more taxes after the marginal rate cut and they paid a 232% larger share of the total tax burden. Those earning less than $10,000, however, paid 28% fewer taxes and their share of the tax burden declined from 3% of the total to 25.7%. The effects, set forth in Tables V and VI are analogous to those recently experienced after ERTA was enacted.

The effects are much more explosive because pre-Kennedy tax rates of up to 91% were, by any standard, confiscatory. The Kennedy reduction in the maximum tax rate from 91% to 70% increased marginal after-tax income by as much as 233% while the ERTA reduction from 70% to 50% increased marginal after-tax income only 67%.

TABLE V

TAXES PAID AFTER KENNEDY TAX CUTS

Net Income Group (000s)	Revenues Collected (000,000s) 1963	1964	1965	Percentage Change 1963-1964	1964-1965	1963-1965
$0-10	$2,624	$2,167	$1,883	-17%	-13%	-28%
10-20	1,371	1,742	1,722	27	1	26
20-50	1,380	1,391	1,555	1	12	13
50-100	638	689	846	8	23	33
100-500	492	625	816	27	31	66
500-1000	87	124	179	43	45	106
1000 and above	131	185	323	42	74	147
TOTAL	6,723	6,923	7,325	3	6	9

TABLE VI

TAX SHARE UNDER KENNEDY TAX CUTS 1963-1965

Net Income Group (000s)	Percentage of Total Tax Burden 1963	1964	1965
$0-10	39.0%	31.3%	25.7%
10-20	20.4	25.2	23.5
20-50	20.5	20.1	21.2
50-100	9.5	10.0	11.6
100-500	7.3	9.0	11.1
500-1000	1.3	1.8	2.4
1000 and above	1.9	2.7	4.4

The other major marginal tax rate reduction was after World War I under Presidents Harding and Coolidge during Andrew Mellon's tenure as Secretary of the Treasury. Table VII sets forth the results of that tax cut. Top tax

rates were reduced from 73% to 25% over four years. Despite such a dramatic rate reduction, federal revenues actually increased 2%. Furthermore, as under ERTA and the Kennedy tax cuts, the proportion of the total tax burden borne by the wealthy increased.

TABLE VII

FEDERAL INCOME TAX REVENUES 1921-1925

Net income class (000s)	1921	1922	1923	1924	1925	Change 1921-25
$0-5	$92,791	$95,591	$81,047	$47,650	$13,909	-85%
5-10	68,871	70,387	55,480	28,827	19,150	-72%
10-15	51,807	49.147	41,899	26,344	22,419	-57%
15-20	41,183	40,430	33,400	25,899	25,090	-39%
20-50	146,608	159,696	132,166	135,187	147,353	0%
50-100	115,712	144,092	108,879	136,636	147,843	+28%
100-500	145,665	213,635	149,493	213,930	236,252	+64%
500-1,000	25,112	38,560	25,499	42,586	53,674	+114%
1,000+	31,419	49,517	35,789	47,207	66,867	+113%
Total	$719,387	$861,057	$663,652	$704,265	$734,555	+ 2%
Maximum marginal income tax rate	73%	58%	58%*	46%	25%	+28%

*The tax for 1923, computed at 1922 marginal tax rates, was reduced 25% by credit or refund under the Revenue Act of 1924.

Why Most Economists' Forecasts Are Erroneous

Why is it that many, perhaps most, economists continue to believe that the path to higher tax revenues is to push tax rates even higher? The answer is that they fail to incorporate the disincentive effects of taxation into their analyses. Within their macroeconomic models lurks a strange sort of "economic man," a person who does not respond to changes in the relative rewards or trade-offs between work and leisure, consumption and savings, tax-sheltered and nonsheltered investments. Human nature is blithely ignored.

The failure to consider the incentive effects of taxation is clearly stated, for example, in the statement of methodology in the CBO report. The report notes that their "estimates do not take account of an individual's behavior resulting from tax changes as they affect the household or the economy at large." In effect, this statement is equivalent to saying that "we are going to estimate the effects of Reaganomics by assuming that Reaganomics does not work." Recall, the point of Reaganomics was the supply-side incentive effects of the 1981 tax cuts.

Indexing Must Be Retained

Beginning this year, the personal exemption and tax rate brackets will increase each year to compensate for increases in the cost of living as measured by the CPI. This provision is most important to lower and middle income taxpayers; wealthy taxpayers are already in the top bracket and, therefore, will remain subject to the same top marginal rate whether the tax code is indexed or not.

Tax indexing is a major step toward assuring honesty and integrity in the tax policy process. It will prevent continued unlegislated increases in real individual tax liabilities that result entirely from the effects of inflation on the tax

system. If tax indexing were repealed, individual and business taxpayers at the lower income levels would continue to be taxed at higher and higher rates. Furthermore, inflation would lessen the value of the personal exemption and zero bracket amount, which are relatively more important to lower income persons.

As noted above, the relative tax burden on the wealthy has increased over the past several years. This is partially because we have had de facto indexing. The 25 percent cut in marginal rates has benefitted lower-income taxpayers disproportionately over the past several years; middle-income taxpayers received a reduction in rates each year -- helping them to compensate for bracket creep -- while the highest-income taxpayers remained subject to the highest marginal rates. The rate cuts helped lower-income taxpayers avoid bracket creep, even though the tax code was not indexed. Inflation increased their nominal incomes, but not their real incomes, and would have forced them into ever higher tax brackets if the tax cuts were not taking effect at the same time.

The Congressional Research Service in a January, 1983, study noted that, because of narrower low-income tax brackets and fixed personal exemptions, inflation disproportionately hurts lower and middle-income taxpayers. It concluded that this continual increase in their tax burden will be stopped by indexing. Instead of increasing the burden on the middle income taxpayers, it concludes that "once indexation begins this new distribution will, for all practical purposes, be 'locked in." That is certainly preferable to increasing the burden on middle-income taxpayers by continued and unlegislated bracket creep.

Record Capital Formation

The Accelerated Cost Recovery System (ACRS) was a cornerstone of ERTA, and it is working. Replacement of the inadequate Asset Depreciation Range (ADR) system with ACRS cut the cost of capital and allowed businesses to make the investment in plant and equipment needed to drive the recovery. As the tables below illustrate, nonresidential fixed investment (equipment and machinery) has increased by 32.4 percent in the eight quarters since the recovery began in the fourth quarter of 1982. This is the highest rate of capital formation in any post-war recovery. The average increase during post-1950 recoveries is 15.9 percent, half of the present rate.

CAPITAL FORMATION DURING THE RECOVERY

Recovery Began	8-Quarter % Increase in Fixed Nonresidential Investment	Investment/GNP Ratio 8 Quarters after Trough
1949	9.3	21.4
1954	10.5	19.2
1958	9.7	15.3
1961	9.0	10.1
1970	10.4	15.3
1975	10.2	14.2
Average of all 7	9.7	15.9
1982 most recent	12.5	32.4

CAPITAL RECOVERY DURING THE RECESSION

Quarters After Peak	Average of Seven Postwar Recessions	Last Recession
1	-2.0%	+0.2%
3	-6.4%	-4.1%
5	-14.2%	-7.5%

Capital formation did not fall nearly as much during the last recession because of ACRS.

Increased capital formation increases productivity, employment and competitiveness. Because pre-ERTA allowances were insufficient, the U.S. economy has fallen behind, stagnated and become uncompetitive. Our capital stock is much older than our trading partners because our allowances have been insufficient for decades. Any further cutbacks in ACRS will sabotage the progress made to date.

The tax law has undergone many changes over the last seven years -- often several major changes in one year. Businesses have watched tax cuts be enacted only to be undone within the year. This sort of activity makes planning difficult. Moreover, it makes every tax reduction suspect and therefore reduces the efficacy of its incentives.

Many businesses choose not to take "advantage" of new tax incentives because they expect the new advantages to disappear. They will not make marginal investments on the basis of tax provisions if they expect them to disappear, thus rendering their investments unprofitable.

ACRS under ERTA was simple. The Tax Equity And Fiscal Responsibility Act of 1982 (TEFRA) introduced new complexities. The Tax Reform Act of 1984 added amazingly complex new rules. This ever-increasing complexity is rapidly undoing the progress made in 1981.

The Capital Gains Tax Story

In both 1978 and 1981 the rate at which capital gains were taxed was dramatically reduced. In 1978, capital gains tax rates were reduced from 49% to 28%. In 1981, the rate was reduced from 28% to 20%. During that period, the definition of capital gain did not appreciably change. In many important ways, the result of the capital gains tax rate reduction was the same as the broader ERTA, Kennedy and Mellon tax cuts. The rate reduction led to at least $2.5 billion more federal revenues and increased the proportion of total taxes borne by the wealthy. It also led to higher taxes on the wealthy. Table VIII shows net long-term capital gains in 1978 and 1981. If we assume, as is almost certainly the case, that those with adjusted gross incomes over $500,000 are in the maximum tax bracket, then capital gains taxes paid by the wealthy were $1.8 billion in 1978 and $4.2 billion in 1981. This constitutes a 130% increase in tax revenues.

TABLE VIII

NET LONG-TERM CAPITAL GAINS 1978-1981[11]

Net Income Class ($000)	Net Long-Term Gains (in billions) 1978	1981	Percentage Change 1978-1981
0-25	$9.7	$13.2	36.1%
25-50	9.0	10.2	13.3
50-100	6.6	11.2	69.7
100-500	8.6	19.0	120.9
500 and above	3.7	14.9	302.7

Even partisans of big government should favor the Reagan, Kennedy and Mellon tax rate reductions for upper income taxpayers. Those tax cuts raised more money for the government to spend. We have not examined, however, the enourmous cost of high tax rates to the broader public. Both those paying taxes and those hoping to have enough income that they must pay taxes are forced to bear the burden of a stagnant economy, devoid of hope and opportunity. Low rates of economic growth have been thrust upon the American economy by those who would rather assuage their conscience by angry rhetoric and misguided attempts to punish the rich when America could have an economy sufficiently dynamic to improve the standard of life for everyone.

Does Business Pay A Fair Share

Liberal groups, such as Citizens for Tax Justice, for years, have been accusing President Reagan of virtually eliminating the corporate income tax. Representatives Pease and Dorgan annually release an "effective tax rate" study purporting to show that the corporate income tax has been gutted. Even the Reagan Treasury has gotten into the game by proposing a tax reform package that raises corporate income taxes by over one-third. The American people have been subjected to a constant barrage of misleading newspaper articles about "undertaxed" corporations. The conventional wisdom is rapidly becoming that corporations simply do not pay their "fair" share.

Rumors of the death of the corporate income tax have been greatly exaggerated. As Table IX above shows, the average corporate income tax rate is over twice as high as those on individual income. If one takes into account all the federal taxes that corporations pay, they pay over 50% of their profits to the government. When state taxes are considered, the burden becomes higher still. Those claiming that the corporate tax is all but dead usually focus on its declining role as a source of federal revenues. But its reduced importance is primarily a function of the precipitous decline in the importance of corporations in American life. In 1950, corporate income constituted 14% of the Gross National Product while today it makes up only 6%. The bottom line is that American business pays a very high proportion of its income to the federal government. Liberal rhetoric is simply belied by the facts.

TABLE IX

FEDERAL TAX BURDEN ON CORPORATIONS

FISCAL YEAR	CORPORATE INCOME TAXES AS % OF CORP. INCOME	TOTAL CORP. TAXES AS % OF CORP. INCOME	CORP. INCOME TAX RECEIPTS AS % OF TOTAL FED. REVENUES	CORP. INCOME AS % OF GROSS NATIONAL PRODUCT	INDIVIDUAL INCOME TAXES AS % OF IND. INCOME
1950	29	34	29	14	7
1960	44	51	28	10	10
1970	48	59	17	7	12
1975	41	58	14	7	10
1980	32	51	13	8	12
1981	31	53	10	7	12
1982	29	55	8	6	12
1983	32	51	6	5	11
1984	25	50	9	6	10

Note: Total taxes include federal unemployment taxes, employers' social security payroll taxes and the corporate income tax.

Those corporations that pay few taxes usually are not paying for one of two reasons. Most have lost money in prior years and are simply "carrying the losses forward." It is only fair that businesses be able to deduct losses incurred in prior years against earnings in the present year. Otherwise, net income is not being taxed. Yet, corporations that have lost money for years and finally earn money are lambasted in the newspapers as "profitable companies paying no taxes." Unless one sees some sort of justice in adopting a myopic year-to-year point of view, the present treatment of losses, where losses and gains are netted out, is correct.

Sometimes corporations pay few taxes when they have embarked on an aggressive investment program and the investment has not yet paid for itself. Our present capital cost recovery allowances approximate expensing. Under expensing, taxpayers do not begin to pay taxes until their investment has actually yielded sufficient profits to pay the cost of the investment. In other words, businesses do not pay tax until they have earned profits.

The Future Course of Fiscal Policy

As we look beyond the impact of the 1981 tax cut on 1982 tax revenues, the positive incentive effects of the tax cuts continue to unfold. The robust expansion presently under way has unexpected power.

What this adds up to is a surprisingly large increase in the tax base. The incentive-based tax cuts have been responsible for an 8.0 percent increase in taxes collected in fiscal year 1984 compared to 1982. In effect, economic growth is increasing federal revenues at the same time it is cutting federal spending. Better business conditions have resulted in higher tax revenues and reduced unemployment benefits.

Having failed to reduce federal spending, some now cast their eyes upon tax reform to close the deficit. They would translate tax reform into a euphemism for major tax increases. But where are the tax revenues to come from?

Evidence provided by the Internal Revenue Service indicates it will not come from the rich. Increasing tax rates on the rich will simply drive them into tax shelters and reduce federal revenues. The Grace Commission has calculated that even if the IRS confiscated one hundred percent of all remaining taxable income above $75,000, it would run the government for no more than ten days.

This means that any tax increase will come out of the paychecks of lower-and middle-income class taxpayers. This group accounts for ninety percent of all personal income tax payments. Their 1981 tax cuts have already been whittled away by bracket creep, Social Security tax increases, and higher excise taxes. How much further can we dip into their pocket books?

The message should be clear by now. Any major assault on the federal deficit must be based on cuts in the growth of federal expenditures. An increase in tax rates would create strong disincentive effects that would eradicate any gains made by reducing the demand for credit by the federal government. Furthermore, it would not lead to anything like the increased tax revenues that proponents of tax increases claim. We must admit that the federal government is an extravagant spender, and that one does not cure the habits of an extravagant spender by providing him with more funds.

Conclusion

The results of the 1981 tax cut are in. They show that these tax cuts have had strong incentive effects. They have increased the share of taxes paid by the rich by causing them to produce more and to shelter less income. They have been a prime ingredient in the current economic expansion. ACRS has caused a dramatic increase in capital formation which is vital for continued economic growth. This proven success should place the focus of deficit reduction on the expenditure side of the ledger. Major tax increases threaten to reverse all the gains that have been made so far.

Senator ABDNOR. Mr. Vedder, you raise an interesting point in the first paragraph of your prepared statement. You tell us that in three instances—the lowering of tax rates in the 1920's, 1960's, and the 1980's—the policy of cutting tax rates was proven successful. Why are we having such a difficult time convincing our colleagues? Any one of you. Mr. Gwartney. Why do they argue the cause of economic recovery?

Mr. GWARTNEY. Well, let me respond to that question in the following way, Senator Abdnor. First of all, I think that substantial progress has been made in terms of changing the thinking of economists on the importance of supply-side responses associated with lower marginal rates. I think the views of the economics profession today relative to what they were, say, 5 years ago and certainly 10 years ago, are dramatically different. So I would say we have made substantial progress in changing the views of the economists.

Second, the issue of why economists think the way they do should be viewed in light of the fact that a generation of economists—two generations of economists, really—were brought up on demand management policies. Their entire mental process, the way they think the world works, what made the economy move, is conditioned by their view of increases in spending, in particular increases in government spending. That view has been under attack, very strong attack, now for approximately 10 years and as a result there has been some movement in terms of how economists think about these issues.

But as in the case of any change, you still have some people back in the dark ages. I think the answer to your question, whether we like it or not, is that a major portion of the economics profession is still back in the 1950's and 1960's, their thinking is within the framework of Keynesian economics.

But if you look at the new modern textbooks in macroeconomics and microeconomics that have come out in the last few years—and textbooks are a pretty good judge of what kind of thinking is going on in a profession—there has been a consistent increase in the emphasis of supply-side factors relating to the incentive structure in recent years.

Thus, I think progress has been made and that we are continuing to make it. However, it is understandable that there are still a lot of people out there who are tied to the old Keynesian paradigm.

Mr. VEDDER. I would agree with Mr. Gwartney. I would say economists under the age of 40, to pick an age, are increasingly very sympathetic to what might be called supply-side views, though they are not a unanimous view, and those over 40 are by and large resistant.

I think part of it goes to the fact that, Senator, the older economists have a lot invested in the Keynesian views. It's kind of hard for a person to come out and, in effect, say, "Everything I did for 15 or 20 years of my life was wrong" particularly when they are on the Government payroll and think that they might benefit from taxes—most economists are on a Government payroll of one sort or another.

So it's kind of hard, I think, to change views.

But I think Professor Gwartney is right, there is some evidence of movement in the profession. The evidence is so overwhelming it's hard to refute. I must say I have only seen one attempt since the 1983 data have come out—maybe others have seen more—that have attempted to refute what we were saying. It was a fairly pathetic attempt by a chap at the Urban Institute who simply said, well, the rich are always paying more because inflation and incomes are going up over time.

Well, taking that into account—these things Professor Gwartney has one way of doing it, I have a little different way of doing it—it's still true that the rich are paying more. Relatively, absolutely, it's true that tax payments as a whole have gone up. All of these things are just hard to refute. I think it takes time.

Senator ABDNOR. Have you seen any change in some of these people?

Mr. VEDDER. I do. Professor Gwartney has written a textbook—he was very modest, by the way—that is very strong on emphasizing this tax thing. I think it takes time; education is a very time-consuming process. I have seen some real switches, even among my colleagues who were sort of—who used to look at me as sort of a heretic, and are down, at least, to listening to me more a little bit.

Senator ABDNOR. Mr. Roberts, how about you, you were one of the early ones?

Mr. ROBERTS. Well, I have seen certain progress since I started these efforts 10 years ago. Professor Gwartney's textbook is one of the examples. It is true that we are having an impact and influence. I think Senator Abdnor, one of the problems is that many economists, especially academic ones, don't really care about the facts or the evidence. They basically just want to punish the successful.

If your goal is to have what they call equity, it is to take away the property rights of the successful and redistribute them, so you

don't really care about the kinds of facts we are talking about this morning.

This redistributive impulse is very powerful in universities. I doubt that it will simply cave in because of the facts. They won't be able any longer to hide behind the manufactured facts. They will have to be more in the open that they don't care about the evidence.

I expect that we will see plenty of statements that they don't care about the evidence.

Senator ABDNOR. Yes, Mr. Rahn.

Mr. RAHN. I think we are making a lot of progress. With the chamber TV programs, we are finding it's harder and harder to get people on the opposite side. I remember a number of years ago, there were very few of us—the gentlemen sitting at this table and only a couple of others around—who were espousing the kinds of views we put forth today. We used to get a lot of invitations because the Keynesians and liberals were the overwhelming majority.

But I have noticed some revisionist thinking on the left. Many are now claiming the recovery was a Keynesian recovery. But if you go back, we cannot find one major leading Keynesian economist who forecasted the type of recovery that we have had, and particularly it being a noninflationary recovery. A few of them said, well, some recovery might be possible, but it would be coupled with rampant inflation.

Yet now many of the commentators—you see the articles in the Washington Post and elsewhere, saying this wasn't a supply-side recovery at all, it was Keynesian recovery. If that is true, why could none of them see it in the past and why didn't they come up with these policies, particularly during the Carter years, to bring us a recovery?

Mr. GWARTNEY. Senator Abdnor, could I add one point to Mr. Rahn's point, which I think is a good one, as sort of a personal footnote.

I debated a Keynesian economist on the 1981 tax legislation at the time it was passed. His forecast was that we would have 30 percent interest rates—if you recall, the interest rates at that time were in the 15- to 17-percent range—30 percent interest rates and an inflation rate of 25 to 30 percent or more, because this enormous demand stimulus was present. I, of course, argued that was nonsense, that there would be a supply-side response.

If, in fact, the recovery, as many people have stated, was a demand-side or Keynesian-type recovery, then we would have had inflation. But inflation didn't accelerate, it decelerated. That shows it was a supply-side recovery rather than a demand-side recovery.

Mr. RAHN. Senator Abdnor, if I may add one thing here too. I think it's very important, as Mr. Roberts indicated, that if we take away the incentives for investment we put in the 1981 act, then you could have a situation where if you just increased demand somewhat through the tax rate reduction, and at the same time penalized people who want to expand the size of industrial plants to meet that demand, then you could have—well, depending on what the Fed did, either inflationary pressures or less economic growth than we should have. We have to remember that the producers, if

they cannot get their money back that they invest, will not invest even if individual interest rates are quite low.

Mr. ROBERTS. Senator Abdnor, last time I looked at the figures in the Economic Report of the President, it showed that consumption growth actually lagged the real growth in GNP, so it couldn't possibly have been a consumption-led Keynesian recovery. By contrast, investment grew at two or three times the normal rate, given past recoveries.

So I think it's quite clear we did not have a consumption-led Keynesian recovery. That's what the figures show.

Senator ABDNOR. Well, this is a direction in which we continue to move. How much lower do you feel you could drop tax rates and still continue to break even?

Mr. ROBERTS. Fifty percent is a high tax rate. That's half of any increase in your income.

Senator ABDNOR. I am not a tax expert, and the first to admit it, but I see the different tax reform proposals around here. I am talking about Gephardt-Bradley, Kemp-Kasten and other plans which cut the top rate to 30 percent or lower. Are those realistic rates? Even though they are doing certain other things that you might agree with, do you think they would generate the kind of income people think they will?

Mr. ROBERTS. I don't think all of the bills would. I certainly do not think the Treasury's bill would. Basically the Treasury's bill is simply a loophole-closing bill that's been on the shelf over there for 20 years. I think the Treasury staff pulled it down, draped a little bit of supply-side rhetoric on it and some lower rates, and they said they had a tax reform. I think that's just a sign of laziness and a nonserious approach to a difficult problem.

Some of the bills on the Hill I see more in terms of leadership on an issue, just to get discussion going, to get people thinking, than actually seriously constructed bills. I don't think they all had the attention they need in terms of whether they raise or lower the cost of capital.

But briefly and more generally, if you will remember, during most of our history we had no income tax on corporations or individuals. This was a period during which we experienced very rapid economic growth, and poverty rates consistently declined, despite the influx every year of large numbers of penniless immigrants, many of whom couldn't speak the language. So a situation of no tax is certainly consistent with rapid economic progress, the absorption of millions of poor people, and a declining poverty rate.

Sometime since World War I, a decision was made that we would rely more on Government to reduce poverty and less on the economy, and we built up massive Government programs and spending that became very large as a share of the national income.

So I think the kind of reform we really need is one that goes back toward the way we used to be, when we relied on the economy to reduce poverty and not the Government. That approach allows you to cut back taxes and Government hand in hand.

Senator ABDNOR. But going back to the pre-income-tax days, there's a lot of difference between the limited responsibility we placed in the Federal Government then, and what we are asking of it today.

Back in those days, the church did a lot in the area of social responsibility, but today it's the Federal Government that has taken over much of this activity.

Mr. ROBERTS. The churches have been crowded out of their responsibilities.

Senator ABDNOR. Mr. Rahn.

Mr. RAHN. If you just look at the evidence we have before us of the tax changes made that clearly those people in marginal tax brackets above 30 percent increased their total tax payments after the tax reduction, clearly we could drop those rates down to the 30- to 35-percent range, top rates, without any loss of revenue there. If you would notice the capital gains tax, as I pointed out in my prepared statement, every time we have reduced it we have increased revenue. A number of us believe you can take the maximum rate down below 20 percent and still increase revenue.

So those are counterproductive. We have seen that the changes we have made in the capital cost recovery so increased the amount of investment that we greatly increased employment, broadened the base, and clearly over the long run they are revenue increasers. To move away from that would be a mistake, even if you want to produce more revenue to the Government.

My own preference is a smaller government rather than a bigger government.

But even if you want to have more tax revenue than you now have, the way to get there is by reducing these high marginal tax rates and income, both individual and corporate.

Senator ABDNOR. I just want to ask you, I am not trying to inject politics in this, but it's amazing to me a couple weeks ago to hear one person get on the national radio and say the rich are still getting off, getting a break, and the poor are having to pay more.

It makes you wonder, with everything you see here, how anyone can make a statement like that.

Mr. RAHN. Because what you have is a number of people in society who are mean spirited and want to punish success. They don't really care about the poor. They care about punishing the rich and punishing successful people. We have seen that through industry.

Mr. ROBERTS. Some people just like to tell lies, Senator Abdnor.

Senator ABDNOR. It was shocking after reading several articles on it, then you hear this report over the radio, this statement, I was shocked. I thought, "Either I have been reading the wrong figures or this person has."

Mr. ROBERTS. These are the Internal Revenue Service's figures and not our figures. These are the official figures of the Internal Revenue Service, and those figures show the rich are paying more.

Senator ABDNOR. If you gentlemen go out into the countryside and talk to the average person, they still think that "the rich are getting all the breaks and I am paying more because of that." How are we going to change that?

Mr. RAHN. A lot of the problem is the news media. The news media does not report things honestly. There is a widespread belief among many people in the news media that economic growth is a zero sum game: For somebody to get wealthier, somebody else has to get poorer.

If that was true, you would see the minimum income disparities in poor countries and maximum disparities in rich countries, and of course the truth is the opposite way. What we have found is rapid economic growth reduces income disparities.

The proper policy is to make everybody wealthy. Until the news media wants to become more educated and get rid of their liberal biases and start reporting the facts to the American people, this is going to be an uphill struggle.

But clearly we are making progress. When President Reagan won the overwhelming majority he did, people intuitively responded to what he did regardless of what the news media said.

Senator ABDNOR. It's amazing.

Mr. VEDDER. Senator, you expressed some, I think, justifiable skepticism at Mr. Roberts' statement that we can't go back to the old days, 1914, before we had any income tax. But if you go to a more modern period, you can go to, say, the Kennedy era of the 1960's, which is the era of a liberal President, just 20 years ago, very much in our lifetime, not that far back. You look back, although we had very high marginal rates for a small number of taxpayers, the ordinary taxpayer, the one you were talking about a minute ago, in those days very seldom paid marginal tax rates of much more than 20 percent.

Mr. Gwartney has done more work on this than I have, but I noticed myself that what a lot of these so-called flat tax proposals—most of which aren't really flat-tax proposals—are trying to do ratewise is go back to the days of the 1960's, when the average taxpayer, or even a moderately high income taxpayer, making what we think of now today as $50,000 a year, in those days was paying in the 20- to 25-percent marginal rate bracket.

That great inflation of the 1970's and late 1960's, particularly in the 1970's, was largely responsible for the problem that we are in now with regard to the incentive effect.

Supply-side economics, as it evolved in the 1970's—and Mr. Roberts and others were involved in it from the start, evolved as part of the response that people were getting pushed more and more every year into a higher and higher bracket. It just became more important to argue for tax rate cuts in the last 10 years than it used to be.

Senator ABDNOR. Yes.

Mr. GWARTNEY. Senator, I would like to pick up on that point and also get back to a point that Mr. Roberts raised earlier. I recently wrote a paper entitled "Is the Flat Tax a Radical Idea?"

In the process of writing that paper I went back and looked at the tax structure in the early 1960's and, admittedly, I was surprised to find that we had virtually an effective flat tax structure in the early 1960's.

Now the reason why I say that is if you look at the number of people who face marginal rates—the lowest marginal rate in 1960 was 20 percent, and then it jumped to 22 percent after a fairly substantial increase in income—89 percent of taxpayers either had no tax liability or paid either a 20- or 22-percent marginal rate in 1962. So virtually everyone was facing the same marginal rate.

At the upper end, even though the rates went to 90 percent, less than 3 percent of taxpayers who filed returns in 1962 faced margin-

al rates of above 26 percent. So basically we had a flat tax structure.

Mr. ROBERTS. Ninety percent of the taxable population was in the lower brackets.

Mr. GWARTNEY. In the 1970's, inflation brought the high brackets to the average American. Instead of 1 or 2 percent of the population facing marginal rates above 26 percent, you had 40 percent of the population.

Senator ABDNOR. What were taxes in relation to the GNP?

Mr. GWARTNEY. Not a whole lot different than it is now.

Mr. ROBERTS. About the same; roughly 18.5 percent. That doesn't change much. All those high marginal rates did was reduce the supply of goods and services. They didn't produce any more revenues.

Mr. GWARTNEY. The high rates are particularly important. I personally feel that the most important part of tax reform is get that top marginal rate down from the current 50 percent to the 30-percent range.

Mr. ROBERTS. What happened in the 1970's, inflation picked the population up which was concentrated in the bottom tax brackets and started spreading it through the middle and upper brackets. You ended up with ordinary people paying tax rates that 10 years before not even the rich were paying. That's basically what happened.

Mr. GWARTNEY. That's right.

Mr. VEDDER. That's right.

Mr. GWARTNEY. Particularly when you tack the Social Security tax on top of that. The ordinary people who are really getting zapped are persons in dual earner families. By no sense of the definition are they rich, but they are facing Social Security tax increases and 40 to 50 percent marginal income tax rates even under the current system. Such high rates do not raise a great deal of revenue.

Even if you look at static projections and I think we have presented powerful evidence that static projections grossly underestimate tax revenues derived from high tax rates—rates above 30 percent only raise about 8 percent of the total income tax revenue.

If you look at the adjustment of the tax base where marginal rates are reduced from 50 percent to 30 percent, the data indicate that you are going to raise almost as much, if not more, revenue at the 30-percent rate, as you raise at the 50-percent rate.

There is one point that we haven't covered yet. I may not cover it in the most effective way. Some of the others may want to pick up on it. We don't want to leave the impression that a tax rate is best that maximizes tax revenues. None of us on this panel believe that. What happens as you get close to a tax rate which maximizes revenue? You have to raise that rate a whole lot in order to get a little bit more revenue as you are moving toward the peak of the Laffer curve, if you like.

When you are in the top marginal bracket you may have to raise the rate 10 percent in order to get 1 or 2 percent more revenue from the people who confront the high marginal rates. That kind of tax rate is highly inefficient. Even though you could squeeze a little bit more revenue if you raised the rates, it's highly inefficient

because it's causing people to do things that they would not do that would result in economic waste relative to what would be the case if we had lower rates.

So if the rate which maximizes revenue is in the 40-percent to 50-percent range as the work of Prof. James Long and myself indicates, you would want to charge a rate that was quite a bit lower than that, because any rate near the 40 to 45 percent is going to be highly inefficient. Some of the other panel members may want to pick up on this point.

Mr. RAHN. That's particularly true over the longer time periods. It is true in the short run that rates of the magnitude that Jim Gwartney has laid out might maximize revenue, but over the longer run they always slow economic growth. So the lower the rate, the higher the rate of economic growth you will have over the long run. Of course, if you would just have 1 percent higher economic growth, you very quickly make up for that lower tax rate.

Mr. VEDDER. We see this also on the point Mr. Rahn made in the evidence from the States. Another way to look at this is let's look at our governments out in the hinterlands, the State governments. Those States that have high marginal tax rates and high income taxes are precisely the States that have been growing the slowest; and those States that have lowered their high tax rates, be it Massachusetts through proposition 2½ or California through proposition 13 or what have you, or don't have any income tax at all, like Florida and Texas, these are the vital States that are growing rapidly.

So any way you look at it, the evidence is clear that the reduction in those rates can stimulate the economy sufficiently by putting people back to work and resources back to work to solve any problems that it might initially create.

Senator ABDNOR. With all of that—I know there are a lot of factors that enter into it—to what do you attribute the drop in the growth rate of GNP in the first quarter of 1985?

Mr. RAHN. First quarter of 1981—1985, excuse me.

Senator ABDNOR. This was awful sudden, last quarter.

Mr. RAHN. You had virtually no growth in the money supply from June to November of 1984, and we know that nominal GNP tends to pace changes in the growth rate by one or two quarters. Now, fortunately, the growth rate of the money supply has picked up some. I would expect we would have a recovery in nominal GNP growth rates.

But last summer there was this clearly erroneous fear clearly on the majority of the members of the Fed that if they allowed a reasonable rate of growth in money supply we would have inflation. They did not understand fully the increase in productive plant and equipment we have had, nor did they understand that the United States was just part of the worldwide economy. They didn't look at productive capacity on a worldwide basis sufficiently, in my judgment. As a result they held down growth rates artificially. That's what we were seeing in the latter part of 1984 and first part of 1985.

Mr. ROBERTS. The problem, Senator, is that the Federal Reserve is operating according to the old theory, the old policies of the 1970's. They really do believe that economic growth is the cause of

inflation, so whenever they see the economy doing well, they tend to act to restrain it.

In my view, the only reason they permitted the strong growth in 1983 and 1984 is they did not expect it. They believed their own propaganda that the deficit would crowd out the recovery, that the recovery would be weak and lopsided, and that the interest-rate-sensitive sectors would be hurt. So under the influence of their own propaganda, they were surprised quarter by quarter by quarter at the economy's performance. They always expected it to fall off a cliff. Yet it kept doing well.

That is the only reason, in my view, they permitted this. It was almost an accident. It slipped by the Fed because they didn't expect it. Had they expected it, they would have jumped on it with both feet and stomped it down. That's basically what they do any time it does well.

Mr. RAHN. Just to give an example of erroneous reasoning over there, last summer I was having breakfast with one member of the Board of Governors of the Federal Reserve. He was warning about capacity utilization rates increasing, when of course they have fallen. It seems to me what was coming through was not understanding that each month we have had a huge increase in our industrial capacity because of the tremendous investment we have had.

Rapid economic growth can actually tend to reduce prices over time. Now, economists seem to understand this when they teach microeconomics. They always have what we call a U-shaped average cost curve.

Somehow these same economists tend to forget this when they get into macroreasoning, particularly the old Keynesian. They have forgotten economic growth increases efficiency. They seem to feel there are these natural limits, which is absolute nonsense.

Senator ABDNOR. I see a change, talking earlier with other economists, and you say you have started to see a change in the attitude of the Federal Reserve.

Mr. RAHN. Well, they have been losing the debates to such an extent it ought to alter their attitude or at least drive them out of the profession.

Senator ABDNOR. Let me close with one last question: What components should a tax reform include to encourage economic growth and what provisions should be avoided? Could you just give us your thoughts on that and go right down the line? I want to give you time to think.

Mr. GWARTNEY. I would like to speak to the personal income tax side. I am sure that Mr. Roberts and Mr. Rahn will want to focus on the business side, but with regard to the personal income tax side, the most important thing I already alluded to is a sharp reduction in the top marginal rates. I think the top marginal rates should not be any higher than 30 percent.

The question comes up, "Isn't that going to lose some revenue?" In a static analysis, obviously it is. In a dynamic analysis, I think it probably wouldn't. But I think there are a couple of additional changes, that in my judgment, that would need to be made anyway. One of these changes is the elimination of the deductibility of State and local income and sales taxes.

The reason why is because basically the current deductibility of current State and local income taxes sends the wrong signals out to State and local governments. It gives them incentive to expand the operations of government, because they can foist part of the cost of that government off on to taxpayers in other States because of the deductibility provision. They don't bear the full cost of undertaking an expansion in governmental activities. An elimination of that deductibility would remove this perverse incentive structure.

Also, there is a distributional issue related to this issue. The primary beneficiaries of the deductibility of State and local taxes are high-income taxpayers, because they are the ones that fill out the itemized returns and tend to have larger deductions for State and local taxes. But not only are they high-income taxpayers, they are high-income taxpayers in high-income States.

So if we are in fact concerned about the distributional issue, the deductibility provision results in a transfer to people in high-income States where government is large, such as New York, from people in lower income, smaller government States such as Georgia, Florida, and Alabama.

Mr. VEDDER. Or South Dakota, if I might add, if I may be parochial for a minute, Senator.

Mr. GWARTNEY. So it strikes me that kind of deductibility from a distributional standpoint is most perverse, as well as the incentive signals that it sends out to people who are local government officials is counterproductive.

Senator ABDNOR. Well——

Mr. GWARTNEY. Would you like to ask a question?

Senator ABDNOR. Yes. Don't you think it would cost heads of State government and local government and put more pressure on the Federal Government to pick up more and more, to make cuts in programs, mass transit, those kinds of things we are trying to put back to the States now?

Mr. GWARTNEY. The States are always going to try to get somebody else to pay for it. There would be some incentive structure in that direction. But let me mention something I think is far more important.

The current system discriminates against user charges, for State and local government activities, because such charges are not deductible. There's a great deal of increase in interest in using various kinds of user charges in order to finance local government operations. That is currently being discouraged.

Once again, user charges would establish a closer link between the cost of conducting an activity and the benefits one receives from it. We will get more efficient operation when we keep that linkage quite close.

A second area of the personal tax structure in which I would agree to some broadening of the base, if I can use that term, which I don't particularly care for, would be in terms of interest deductibility on schedule A, which is basically for nonbusiness activities.

The home mortgage interest deductibility encourages home ownership, and that is something that I think is good. From a political standpoint, as well as from an economic standpoint, one could certainly build a case for it. I favor maintaining the home interest deduction, but I do not advocate it for consumer credit loans or signa-

ture-type loans for people to use debt rather then equity as a method of financing.

With those two modifications, plus the substantial reduction of the top rates to 30 percent, you could easily devise a revenue-neutral proposal that would also permit you to reduce rates in some of the lower brackets. So those are the major modifications I would make in personal taxes.

Senator ABDNOR. What about tax advantages of insurance benefits, as you see now?

Mr. GWARTNEY. The fringe benefit packages, you are speaking of?

Senator ABDNOR. Yes.

Mr. GWARTNEY. The problem I have with so many of these is they add complexity to the system. I realize there is an argument to divert people away from taking compensation in the form of fringe benefits, rather than wages and salaries, but the lower marginal rates, Senator, will go a long ways toward solving that problem. The lower marginal rates make it less attractive to devise various kinds of schemes. Most of these things have costs associated with them: Profit-sharing plans, pension plans, things of this sort. The lower marginal rates in my judgment will be sufficient to remove the incentive to undertake schemes in this area.

Senator ABDNOR. Mr. Vedder.

Mr. VEDDER. I would agree with Professor Gwartney. In fact he stole most of my thunder, because I was going to make the same point about State and local deductibility. I agree with everything he said.

The one thing that is a major consideration in a tax bill is how do you want to define the tax base; in terms of income, using income as the basis of taxation, or to what extent do you want to use consumption as the basis of taxation.

I think there is a very serious case that can be made for excluding savings from the tax base, not only on the grounds of economic efficiency, but also on the grounds of equity and fairness. I, therefore, would personally be willing to see one erosion of the tax base, if you want to call it that—I don't like that term either, but if you want to call it that—come in the form of more generous allowances for the deduction of savings as a means to encourage savings and capital formation.

Again, on the business side, I think there's a need to integrate. There's need for some important reforms there, but I would rather refer to my colleagues on that who are perhaps more expert on that subject.

Senator ABDNOR. Mr. Roberts.

Mr. ROBERTS. Senator Abdnor, Professor Gwartney has pointed out that allowing the deductibility of State and local income taxes can cause them to be higher. He is correct. For example, if you are in the 50-percent bracket, and the State raises income taxes, you only pay half the increase. If you are in the 25-percent bracket you only pay three-fourths of the increase. So it is true that the deductibility of State and local taxes reduces the cost of them to the taxpayer, who has to pay them. Nevertheless, I think your point is correct, too: If you are trying to trade back responsibility to State

and local governments, you don't want to do something that makes it more difficult for them to accept that.

And I think also you have the old question should you pay taxes on taxes? That is something that is very disturbing: If you are going to pay taxes on taxes, you might get in a situation where there is no income left to the earner.

So I think on the whole, it's very hard to know how this thing works out in practice. Mr. Gwartney has a point, but how it mixes in with all the other considerations and how it works out, we don't know.

Take the fringe benefits. If you tax fringe benefits, the first thing it is going to do is to increase the demand for the Federal Government to provide these benefits. If you tax medical insurance, all of a sudden the demand for federally supplied medical programs is going to go up.

One thing we do know as economists is that generally people would prefer to receive an extra dollar of income than to receive it in kind—that is, in the form of benefits—because a dollar gives you command over all goods as opposed to some specific kind of benefit. It's the nontaxable nature of the fringes that has led to their growth. If you were to start taxing them, you would probably see people saying, "Well, just give us the dollar income." Then you would tend to see the decline of privately provided fringe benefits and the demand that they be provided by the Federal Government. On the whole that's not a very good idea, especially if you are trying to control the budget.

From my studies—let me say something about the personal tax rates. What is an appropriate personal rate? In the middle of the last century Karl Marx was trying to figure out where free men and women came from—that is, how did they evolve? I am not quite sure he ever figured it out, but one of the things he did hit on was the difference between a free man and a serf: The serf had to pay income taxes, the free man didn't. Marx' definition of free labor was a person on whom the government had no claims. A serf was a person that owed about one-third of his working time to the State.

Now, when I was a graduate student at the University of California, Berkeley, and later at Oxford, I looked into what were the tax rates on serfs. Obviously it differed over time and regions. But on the whole, it seems that on average serfs paid about one-third of their working time to the government. So a serf was a person who paid a tax rate of 33 percent, and free man and woman faced a tax rate of zero percent. That seems to me to be historical fact.

So if we want to elevate our present status to the status of serfs, the top rate would be 33 percent. If we were to achieve that, we would once again be in the same condition as the serfs, in that we would own two-thirds of our labor time and the State would own one-third. It would seem to me that at least we ought to be able to restore the conditions of serfdom. A democracy ought at least to be able to achieve that.

Now, to briefly make a point, having served as Assistant Secretary of the Treasury and having served on the congressional staff a number of years, I am convinced that neither the Treasury nor the congressional staff have the ability to design a tax reform.

It's a major tax reform. It's more likely to contain more surprises than many anticipate, and its disruptive effects are likely to be quite serious.

So perhaps the best thing that we could do is to cut the rates again. If we just cut the tax rates, we don't have to worry too much about where we are raising the cost of capital and what industry is going to catch it next, for example, like mining in the case of TEFRA.

So perhaps the best thing to do is just, again, lower the rates, because as these rates are lowered, as they come down, they automatically have the effect of closing the loopholes, because the loopholes become less valuable and fewer taxpayers want to use them. It's left to the market, and these decisions get made in a less disruptive way. So given the fact that I, based on personal experience, have no confidence in the Government's ability to design a tax reform——

Senator ABDNOR. Just a minute. I think I can understand the Congress: We have to take care of our own personal constituents and what is good for the voters. But don't you think Treasury, by the time you get the two together——

Mr. ROBERTS. The administration does the same thing you do. They do it before they send their bill to the Congress.

But over and above all that, the Treasury staff thinks about it in static terms.

Now, an hour's thought on the part of an undergraduate student in economics could have predicted the effect of the minimum tax on the mining industry, but the entire staff of the Department of the Treasury wasn't able to. So if you turn them loose on the entire Tax Code all at once, there's no telling what the effect would be, because they calculate the result in terms of static revenues. Taxes go up or down. There is no behavioral response in the supply of labor. Capital doesn't change, just the tax rate. You go through the Tax Code in that way, and you are going to produce more surprises than the Government can survive. That's my view.

Senator ABDNOR. I won't argue that. Mr. Rahn.

Mr. RAHN. Well, obviously, I pretty much agree with my colleagues here.

What I see happening with all these tax reform proposals, is because, again, since they are bound up with static revenue analysis, which we know is absolutely wrong, if they want to go ahead and reduce rates on individuals, they think to have to raise it someplace else. So they all propose increasing taxes on business and in particular tax recovery allowances, corporate minimum taxes, and so forth, all of these will be highly restructured.

Craig Roberts gave a perfect example of the corporate minimum tax and how it did in the mining industry. The increased capital cost recovery allowances will kill investment and they will wonder why we have had tax reform but no economic growth. I see a tremendous danger here.

So I would urge you all, more than anything, to reject this canard of the static revenue analysis, because we know the static revenue figure is wrong. We all know that is wrong. Because we cannot maybe precisely agree on what the dynamic revenue figure ought to be does not mean maybe we should not use it.

Senator ABDNOR. Senator D'Amato has just arrived. I was hoping you would get here earlier, because you have a great interest. We have had, at least to me, a very interesting discussion here. I was listening and they were talking.

Senator D'AMATO. Do they support, Senator Abdnor——

Senator ABDNOR. That's for you to find out.

Senator D'Amato is one of those who feels very strongly, I am sure, about State and local taxes.

Senator D'AMATO. Absolutely.

Senator ABDNOR. I have been asking them questions a long time. Would you mind taking a few here?

Senator D'AMATO. Let me thank the Senator for calling this hearing. I am sorry that another subcommittee kept me from arriving here earlier.

It just strikes me if you take something that is a tax reform for fairness and simplicity and economic growth, how could anyone be against that? Is anyone here against reform for fairness and simplicity and economic growth?

Mr. ROBERTS. You should file suit against the Treasury for mislabeling, that is what you should do.

Senator D'AMATO. We didn't put "apple pie and the American way," but is anyone against the principle of tax reform for fairness, simplicity, and economic growth? Does anyone want to comment on that?

Mr. RAHN. Well, the Treasury——

Senator D'AMATO. I am not talking about the specifics of the plan.

Mr. ROBERTS. The words sound great.

Mr. RAHN. If any of those three words could be applied to that document, I think that some of us would have a little more positive reaction. But all of those comments are not applicable to what is inside of that book.

Senator D'AMATO. I have several questions, and I know time is important, but when we talk about doing away with the deduction of local taxes, State and local taxes, let's turn to that one area.

In your view—and if anyone wants to answer it, I would be delighted to hear it—would there be an adverse economic consequence or any economic consequence from doing away with just one aspect of the deductibility of State and local taxes? Would that affect the value of home ownership, if it would affect the value of home ownership, to what extent, and would it make it less attractive? I happen to think it would. And would there be economic consequences—in other words, less building, less people working, et cetera?

Mr. RAHN. Of course what you have just said is absolutely correct, because you have increased the price of housing if you take away the deduction. If you increase the price of housing, then you are going to have less of it. That will have a tremendous effect on the construction industry, on the forest products industry, and all those other people that provide materials for housing. It will also mean that Americans will be less well housed.

Senator D'AMATO. Mr. Roberts.

Mr. ROBERTS. One aspect of the property tax is that it applies to the same asset year after year after year. It really is one of the

worst taxes in the sense of raising the cost of capital, so I would not want to see the loss of that deductibility.

Other reasons favor deductibility. Once there was, at least in principle, at one time, sort of the view that you shouldn't pay taxes on taxes. I know we don't really abide by that. We pay taxes on Social Security taxes, which raises, of course, the tax rate.

So I don't think that we really want a system, particularly when we are already fairly heavily taxed, in which taxes are taxed.

Senator D'AMATO. Mr. Vedder.

Mr. VEDDER. I am a little ambivalent on the desirability of removing the deduction on real property.

I will say this from my own studies, I have studied at the State and local level the relationship between economic growth and property tax burdens at that level. It is true that there is a very significant relationship between the level of property taxation and the rate of economic growth. The higher the property taxes, the lower the rate of economic growth.

I would agree with Craig Roberts in the sense——

Senator D'AMATO. If I might, if we were to stop at that point and say that recognizing that the high rate of taxation burden locally, that the brief economic growth is curtailed, if we were to say that now you could not even deduct that from your Federal taxes, wouldn't that even more adversely impact those areas, or would it just compound the problem?

Mr. VEDDER. Yes; although it would provide some incentives to reduce those taxes too. I am aware where you are coming on this, Senator.

Senator D'AMATO. You can disagree with me.

Mr. VEDDER. There are political problems socially with that, but there is that relationship. And how that falls out politically or how one handles that in a policy sense, I am a little uncertain.

I think both taxes, the property tax and the income tax, are two most evil taxes, essentially, in terms of economic growth.

If you were to take the money you saved, so-called saved—I hate to use that word—by somehow removing deductibility on the property tax, and you used it to lower Federal marginal rates, then you might come out with a wash on it. I am not convinced that would happen, and I am not convinced that that would come out that way, so that's what makes me a little bit ambivalent. So I am kind of ducking your question.

Senator ABDNOR. Before you continue on, I am going to have to go. Will you continue on with your cross-examination? He has a meeting too, I know, so you won't be here all afternoon. I know he has a few questions, but I just have to go. I want to say to all of you, thank you, very, very much for your time. I am sure you will make a great contribution to our yearly report. Thank you very much.

Senator D'AMATO [presiding]. Thank you, Senator Abdnor. Mr. Gwartney.

Mr. GWARTNEY. Well, we have had such a harmonious meeting, in terms of the views of the panel, that maybe I better throw something in so that there won't be any question about the hearing being set up as to the views that the people had.

I recognize, of course, you come from a State where the deductibility of State and local taxes, and particularly the income tax element, is quite important, Senator.

But as an economist who believes that the way the system works best is when we come up with a system where the people pay the full cost of the things which they are able to consume, and they at the same time bear the hardship of the cost they impose on others—I think that's the sort of system that works best—I personally cannot justify the deductibility of State and local taxes.

Your colleague Senator Moynihan had a recent column in the Wall Street Journal tying this in with federalism. Neither can I tie it in with federalism, because federalism is experimentation on the part of States playing on a level playing field trying different things. Some States discovered things that work and other States emulate those things that work. Still other States discover things that don't work and they are forced to withdraw from those kinds of things. This is what federalism is about.

In contrast, the deductibility of State and local taxes permits a State to expand the size of its governmental sector and in the process of doing so not bear the full cost of it. That to me is the major issue. I would expect together State and local governments—and particularly that segment of State and local governments that is not involved in the provision of our infrastructure to undertake uneconomic activities and to establish tax structures that are uneconomic.

Senator D'AMATO. What about the people, Mr. Gwartney?

Mr. GWARTNEY. The people within those States?

Senator D'AMATO. Citizens.

Mr. GWARTNEY. They are able to experience governmental activities without bearing their full costs. They bear less of the cost of the activity because the deductibility of the Federal provision permits them to foist the cost on to residents of other States.

I think that States that have adopted highly progressive income tax structures would not have adopted that kind of tax structure had it not been for the deductibility of the Federal system.

Senator D'AMATO. That's a fair argument.

Let me, for the purposes of the discussion, ask you two things. Is it fair to the individual citizen, though, to have him or her placed in a position, whether that citizen was in New York or any other area, where the Government is, in effect, taxing them for income that they have absolutely no control over, or they do not keep as disposable income; is that fair?

Mr. GWARTNEY. Well, presumably they are getting some public services in exchange for those tax payments to the Government. If they are not, they better start policing their Government.

Senator D'AMATO. Mr. Gwartney, let me ask you this: What is your position with regard to double taxation on corporate dividends?

Mr. GWARTNEY. Well, I don't think that is exactly the same kind of issue.

Senator D'AMATO. Same Treasury report. Let's understand they talk about reducing the burden for corporations, because corporate dividends are taxed twice. They view that as an evil in need of a remedy.

Now, we are not suggesting that all State programs, et cetera, that none of them have a useful purpose, humanitarian, that may not flow to the particular individual, but does flow to governments as a society, and that people don't have some obligation.

If we look at it in that manner, if the double taxation of corporate dividends is not proper and viewed as something detrimental to the economic system, why wouldn't the same apply to individuals who will be forced to pay a tax on income that they don't have to dispose of?

Mr. GWARTNEY. At the State government level, individuals are getting benefits in addition to the costs; and if, in fact, the benefits were spread—if you could build the argument that if New York provides more public housing projects or various kinds of industrial bond interest——

Senator D'AMATO. And there's a national purpose in that taking place?

Mr. GWARTNEY. That's right.

Senator D'AMATO. Isn't that the case?

Mr. GWARTNEY. I don't feel a great deal of benefits from public housing projects in New York as a resident of Florida.

Senator D'AMATO. I would suggest to you that political expedience makes it easy to beat up on particular areas, New York being one of them. But over the years New York has played a very dominant national role in housing the poor, being the first port of entry for so many, and educational opportunities, et cetera. I would suggest you will find other regions of the country, as time goes on, that will be doing that.

But we are going a little far afield. I think that the economic consequences with respect to the deductibility of State and local taxes would have an adverse economic impact, and that will be true in New York, New Jersey, Connecticut, Colorado, and Florida. Wouldn't you say that this is true?

Mr. GWARTNEY. Well, the home ownership——

Senator D'AMATO. If the people of Colorado can no longer deduct their local real property taxes, doesn't that make their property, their home, less valuable?

Mr. GWARTNEY. Yes; it does.

Senator D'AMATO. Doesn't it indeed also raise the likelihood that there will be less homes constructed in Colorado or, for that matter, any other place in the country?

Mr. ROBERTS. Maybe less private homes, but the Government may use the revenues then to provide public housing.

Senator D'AMATO. Isn't that a fair conclusion even though that might go contrary to what you believe? I see you are not sympathetic to the deductibility issue, but let's look at taking away the ability to deduct local property taxes that a person pays on their home. I think we will all agree that it makes that property less valuable; is that true?

Mr. GWARTNEY. That's correct.

Senator D'AMATO. That makes home ownership less attractive in the future, isn't that true, to others who are thinking of purchasing? Is that true or not?

Mr. ROBERTS. Depends on the alternatives, but generally speaking, yes.

Mr. VEDDER. What are you going to use the money for?

Senator D'AMATO. There are other alternatives, but now that we have made home ownership as a concept less economically attractive, the fact is that if we look at it, there will be economic impacts on the construction of homes.

Mr. GWARTNEY. But markets are going to adjust to that rather rapidly, Senator, the case of deductibility, even of property taxes and home ownership. Since property taxes are almost like a user charge, where things related to property such as sewers, roads, schools, and particular things that are very close to the people, are primarily financed out of property tax revenues, so individuals are getting benefits in addition to getting the taxes. My question would be, How does that differ at the individual level in terms of benefits that an individual gets if they build a new room on their house? They also get benefits and they also bear a cost. They will make that decision on the basis of balancing the costs relative to the benefits that they may or——

Senator D'AMATO. I have a problem. Let me tell you what the problem is. By the way, it goes back to this whole theory that if something isn't working, don't tinker with it.

Is there anything that you would really suggest that would on an economic, moral, legal basis, suggest that we should tinker with an area that I think is a vital one to our people nationwide, the concept of home ownership, something that we have advanced for years regardless of what the tax rates may or may not be?

There was a plausible argument for doing away with local real property taxes as a deduction. Do we find that so repugnant? I have a feeling that if we talk about what the benefits may be, and understanding exactly what we are going to lose, that the two don't stack up. It's not a good bargain for the American people.

Mr. RAHN. Senator, I think there's a way out of this whole dilemma. What we are talking about are possible tax increases. I think all of us here are against increasing taxes.

The problem is the Government has been spending too much. Now I think that you and the Senate have a great opportunity before you with the leadership-White House compromise bill. If we get that reduction in Federal spending passed, that will take off the pressure to increase any of these taxes, which are clearly undesirable, and I would hope that you would go ahead and vote for that.

Senator D'AMATO. Well, one of the things that we are talking about here is that without the deduction of State and local taxes, as taken now, the taxpayers of America, the citizens, will be paying $40 billion more; isn't that true?

Mr. ROBERTS. They will experience a wealth loss.

Senator D'AMATO. Of $40 billion, that one call will result in their losing $40 billion.

Mr. RAHN. But the way to avoid those kinds of pressures is to reduce the growth rate of spending.

Mr. GWARTNEY. And to reduce it by reducing the tax rates. That's the first point.

Senator D'AMATO. But if we want to cut them, let's reduce those rates, instead of reducing them on the backs of the middle class by reducing the value of homes and concept of home ownership.

It's not very politically popular for the deduction provisions, for example, for people who own a second home. I would like to say do you know when we do away with the deductions on people that own second homes, we better look at the consequences.

A lot of homes have been built in Florida, Colorado, Arizona, eastern Long Island—where I come from—the Hudson Valley area. What happens to the values of those properties? It is diminished. What about the hundreds of thousands of men and women who have direct and indirect economic results, consequences, as a result of the fact that the investors are advised to build that home and take that deduction.

Are we going to say with one fell legislative action that we are ready to gamble that things are going to find a way in a new system that is going to be better than this?

Mr. ROBERTS. I wouldn't be willing to do that, not based on the low quality of the work that's been done by the Treasury staff. I might be willing to gamble it based upon a much more competent analysis and approach, but I wouldn't be willing to gamble it on what you held up when you walked into the room.

Senator D'AMATO. Anybody else?

Mr. RAHN. We would be opposed to the removal of the property tax deduction also.

Senator D'AMATO. Let me just pose one other question. I think there are many valid reasons that could be put forth, but they are economic in nature.

The thing that bothers me is we have not given the American people all of the facts. In other words, when you put forth a program, shouldn't the American people know that there are economic consequences, how many jobs will be affected? It's one thing to say to someone, "Well, I am going to propose a system where you pay 10 percent less in your taxes or 5 percent less in your taxes," and I think there are areas of loopholes that should be closed. I think minimum taxes should be established. I have no problem with that. I think that's an element of fairness.

But the same person you are saying you are going to benefit, what happens if he or she as a result of this program no longer has a job? I think many Americans don't recognize when we say, "Well, what do the economic studies say," we are really talking about how many people will now be employed directly and indirectly as a result of a change in tax policies.

Mr. GWARTNEY. Senator, let me respond to that in the following way. I think we are really mixing up two issues here. One is the adjustment process. If these forces are transferred from one area of the economy to another area of the economy, the way a market system works is prices go down in one area, which sends a signal to resources that too many resources are being channeled there. Incomes fall. Profits fall. Resources are moved from that kind of an area over into another area of the economy.

There are costs associated with these kinds of transitions. They should be taken into consideration in terms of our viewpoints about the attractiveness of various kinds of tax reforms.

But there's a second issue, one which I think that a couple of the examples that you used were a bit misleading. I realize it's danger-

ous for a college professor to tell a Senator that his examples were misleading.

Senator D'AMATO. It's also dangerous for me as a student to suggest that to a professor.

Mr. GWARTNEY. But Frederic Bastiat, a French economist, once made the statement that the difference between the good economist and the bad economist is that the bad economist only sees the things that are immediately observable and the good economist sees, in addition to the things that are easily observable, the secondary effects that generally go unseen.

With regard to your example of home ownership of second houses being affected by the removal of the interest rate deductibility, that is true. Fewer resources will go into production of second houses. But those resources do not suddenly disappear. If we reduce marginal rates accordingly to offset that change in the one area, you will find resources flowing out of the second housing market and into other things where they have a higher rate of return.

Senator D'AMATO. Let me suggest to you one thing.

Mr. GWARTNEY. Let me——

Senator D'AMATO. I am not going to disagree with you on that point.

Mr. GWARTNEY. If you look at one side——

Senator D'AMATO. Stop right there, then I will let you continue. At that point, we have agreed, fewer resources will go into housing if you do away with the deductible for second houses. This is one person who says I like what I see, an emerging pattern, within the last decade or two decades, for senior citizens or people who reach a certain point in time in their lives, will buy that little place up at the lake, if it makes economic sense for them to do it, where they can gather with their family, or whether it's in another State, they will spend their winters and then come back, and it makes sense for them. I think that's good.

I don't want to see those economic resources go into another area. Why should we, because someone says, you know, if Americans will spend $10 billion less in housing, they will spend it or invest it in a higher yield area?

But I think as it relates to those two specific examples, it is something that is good that people who are in the lower economic areas want something they can look forward to when they can own their own, and those that own their home, it will be worthwhile and prudent for them to make an investment for a vacation place. I don't disagree with you that those moneys will go into something that will be productive of some kind, nor am I opposed to limiting the rates.

I would rather, though, why not have a minimum tax where you have people and corporations who really create this image of an unfair progressive tax taking place, whatever that rate may be—15 percent, 12 percent, whatever that limit—and then apply those revenues or do away with the nonproductive tax shelters where you get 4 or 5 to 1, and lower the rates, rather than attack this.

Mr. GWARTNEY. Well, Senator, my response to that is I do not know whether the best choice for a citizen to make is to spend funds on a second home in Florida.

Senator D'AMATO. But is it not a citizen's right? We have encouraged them. Who are we now to say that is a bad thing?

Mr. GWARTNEY. My point would be I would not now say it's better that they spend funds on a second home in Florida than, for example, on a vacation in Yellowstone. I don't want to say that in one case we are going to encourage it through a tax deductibility system and the other case we are not.

Senator D'AMATO. We have done that, Mr. Gwartney, for 50 years. Now this instrument says no longer should Government be involved in what you want—in tax policy being an instrument of social policy.

Mr. GWARTNEY. That's right.

Senator D'AMATO. But we have done that.

Mr. GWARTNEY. We have, but it is based on the assumption that a committee of 536 is smart enough to plan to build little nuances into the tax structure favoring this kind of proposal and opposing this kind of proposal. I don't think they are that smart. I don't think I am that smart either.

Senator D'AMATO. I agree with you, then. Let me say this: Let's do away with the deduction of State and local taxes. Let's do away with that deductibility. Let's also do away with the Federal tax credit that we give to people who pay foreign governments taxes.

Why should we give to an American who pays the French Government $10,000 in taxes the right to deduct that $10,000, take a total tax credit? Not even from his adjusted gross income: What we are saying is if you are an American citizen, and you pay taxes to the French Government, you can take a tax credit, but if you are an American citizen who pays taxes, someone who lives in New York or a State like New Jersey, you can't even deduct that from your adjusted gross.

Where is the difference? One, you say, we are taking a policy. This is a policy that we want to encourage people to work abroad, earn money, let's. So we let them take a whole tax credit for the amount of taxes paid abroad. Tax credit. I don't even think the American people know what that is in most cases. They can take a credit from their U.S. tax liability. But the bad State of New York—we all know it's a bad State, so if you pay taxes to the bad State of New York, you won't be allowed to take a tax deduction from your U.S. taxes. Is that right?

I want to say to you, how do you feel about doing away—and shouldn't this document then say, because we want tax fairness, there are millions of Americans, millions and millions who don't pay taxes because of foreign tax credits, then shouldn't we also put in here a provision that says no deduction, no taking a tax credit, if you pay to a foreign government? This would keep everything on the same plain.

Mr. GWARTNEY. Perhaps that is a good idea.

Senator D'AMATO. If we are going to come out and say to people, we want you all to be fair, I want to be fair, New Yorkers or New Jerseyites or people living in Connecticut, not to be able to deduct their taxes, they shouldn't be able to do it. But those people who live abroad, American citizens who pay taxes, they shouldn't be allowed to earn tax credits.

Mr. GWARTNEY. Let me say you are taking me afield of what I would consider my area of expertise there.

Senator D'AMATO. Typical professor.

Mr. GWARTNEY. Let me also say that you defend your case very persuasively.

One point I would make, as a Floridian.

Senator D'AMATO. By the way, if they do away with the deduction of local property taxes, and interest on second homes, you are going to have more properties in Florida that are going to go down, that people aren't going to be able to hold. It's not going to make economic sense to them if that's the way they make those judgments. We are going to see a loss in jobs that are being created for all those people that are building those nice high rises, little buildings, we are going to experience the same thing in other areas of the country. It's an area that so many people can disagree on. Why tamper with it? Why touch that area of deductibility? And answering your point about government responding, if in 1 year you enact a policy that says no longer can those of you who deduct State and local taxes deduct it, it's unreasonable to think that any State government can react, as much as they might, to lowering those taxes, in a manner that would be consistent with keeping businesses to stay in that region. This has not provided an orderly transition. If you were to say at the end of the first year, you can only deduct 95 percent, at the end of the second year 90 percent, and so on, this way at least it would be fair. You would put the pressure on local and State governments to then begin to reduce that tax burden; otherwise, they would see the migration of people out who would react to the economic benefits of people living in other areas.

Wouldn't that be a better manner to approach this, rather than change the tax policy, that has been in effect for over 50 years?

Mr. GWARTNEY. I will accept your amendment as far as the transition is concerned. I would make the schedules considerably more accelerated there than 95 percent of that, et cetera, the one you proposed, but I think the idea of phasing out this kind of a deduction is a good one.

Senator, one of the things that you said related to my home State is already a problem. I would argue it is related more to the reduction in the top marginal rates than to the deductibility.

That is, you will find as you go up the east coast on what we call the gold coast of Florida right now, that the vacancy rate of condominiums is exceedingly high, and that there has already begun to be a reduction in the level of construction activity in that area. It is reflecting the fact that the high marginal rates, which made those kinds of activities more attractive before, are now making them less attractive.

The very act of reducing the marginal rates will tend to have those kinds of feedback effects. But I would argue that moving resources out of areas which have been favorably tax treated and into areas which, although they are taxed, have higher yields is a step in the right direction. Transitional issues aside, from the standpoint of the economy, such moves improve the efficiency of resource allocation. I agree with your point. I think it's well taken about the costliness of the transitions.

Senator D'AMATO. The shock of—for example, in our State, the citizens—this isn't the Government, not the State government or the local government—the individual citizens would lose $4.5 billion.

Mr. GWARTNEY. But think how much better government they would get from New York once the citizens of New York——

Senator D'AMATO. I think that, for example, we are beginning again, since the economic recession, to cut taxes. I think it's important. I support that. I am talking about the State level. I absolutely do. I would hope it would be an ongoing thing. Our Governor has cut the taxes. I support him and the State legislature. They have worked out a compromise. If I had my druthers, I would like to see more of it. Better to give an accolade for some light than to say, oh, it could be better.

No, no; I am delighted, but I think we have to continue more. I think if you have a phasein of this deduction—by the way, I don't think they should touch the local property tax, because I think you really affect then the entire economy of this Nation. There will be economic fallout that is far greater than the home construction, furnishings, and servicing area, than I think most people really realize.

Another area is that we haven't conceded to the Japanese yet. If we give people more spendable income and they are going to buy more foreign imports to come in here, tell me about the economic benefits. If we don't get a tax policy—I say tax policy, economic policy—that recognizes the two-sided trade that we have had, I am shocked. We are supposed to be happy that the Japanese are now going to open up their telecommunications area, maybe, a whole $4.5 billion industry, and maybe we will get 20 percent, which would come to $800 million. That's nothing, that's a pittance, that's a joke. They still haven't done it.

So there are some areas, and maybe the committee will hold some hearings and have you testify with respect to what is a fair and balanced trade program.

I know we are well far afield with that question.

Mr. GWARTNEY. Senator, let me make just one final point with regard to this issue of State and local taxes, I think it is an important issue.

We have just gone through a period of time where the major functions that State governments, in particular, undertake have been expanding very rapidly. We are going to go through a period of time where the cost of the things that the State and local government traditionally had major responsibilities for are going to be falling as a result of demographic changes.

It's just the opposite of what is happening at the Federal Government level. At the State government level the major functions are education and things relating to children.

As you are aware of, in the last 15 years we have had a big bulge in the population between ages 5 and 20. Therefore, that has tended to propel State expenditures very rapidly during that period of time.

We are now going through a period where it's predictable that in the next 10 to 15 years, the number of people in the age bracket which tends to have the greatest impact on State expenditures is

going to be declining, thus, State and local expenditures are going to increase less rapidly in the next 15 years.

At the Federal level, a major item of expenses relates to the elderly.

Senator D'AMATO. Yes.

Mr. GWARTNEY. Medicare, Social Security, all these programs. Thus in the next 15 years we will have a rapid expansion in the population 65 and over.

Predictably there is going to be increasing pressure on Federal expenditures due to these demographic changes and at least some diminishing of pressure on State and local government expenditures.

As you are well aware, the Federal Government is running a very large deficit at the same time State and local governments are running surpluses. When you look at the demographics in the current budgetary situation, it's hard for me to justify the deductibility.

Senator D'AMATO. Maybe the 20-year phaseout I have called for would be reasonable.

Mr. GWARTNEY. With that note, I will quit beating a dead horse. Thank you.

Senator D'AMATO. No; I think that is an excellent one. Let me first of all apologize for keeping you so late and thank you on behalf of Senator Abdnor for your contributions, for being here, for making known your views. I will be reviewing the record, and reading it in some detail. I know some of you personally and know where you are coming from. I think the bottom line is we have to get a grip on spending, and that really is the key.

One of the great problems is everybody says "Don't cut my program." I am offering that as waging a battle, not to do away with mass transit, it's something the doctor and I were speaking about. I think this is an area where we have to cut across the board, but I don't think that you try to do it at the expense of one area or one sector. If you do it, phase it out consistently, not only this year or next year, but that's the way we achieve that and bring it up to the level of economic growth we want.

Let me thank you very much. Thank you for giving me the opportunity to personally voice some of these questions to you. The subcommittee stands adjourned.

[Whereupon, at 12:28 p.m., the subcommittee adjourned, subject to the call of the Chair.]

[The following written questions and answers were subsequently supplied for the record:]

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Response of James Gwartney to Written Questions Posed by Senator Proxmire

Congress of the United States
JOINT ECONOMIC COMMITTEE
(CREATED PURSUANT TO SEC. 5(a) OF PUBLIC LAW 304, 79TH CONGRESS)
Washington, DC 20510

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ROBERT J. TOSTERUD, DEPUTY DIRECTOR

April 30, 1985

Dr. James D. Gwartney
Department of Economics
Florida State University
Tallahassee, Florida 32306

Dear Dr. Gwartney:

I was not able to attend the April 23, 1985, hearing before the Subcommittee on Monetary and Fiscal Policy during which you testified on the hearing topic of "Tax Reform, Tax Rates, and Tax Revenues." I do have some questions that I would appreciate your answering for the hearing record, including some specific questions on the tax issues raised during the hearing and some more general questions on supply-side economics. The questions are attached.

You may submit your responses either with your corrected hearing transcript or directly to Mr. Ed Jacobs at the Joint Economic Committee, G-01 Dirksen Senate Office Building, Washington, D.C. 20510. I would also appreciate having a copy of your responses for my own use.

Thank you for taking the extra time to answer my questions.

Sincerely,

William Proxmire
U.S.S.

WP:rkt

Attachments

QUESTIONS SUBMITTED BY SENATOR PROXMIRE

TO WITNESSES TESTIFYING APRIL 23, 1985, BEFORE THE

SUBCOMMITTEE ON MONETARY AND FISCAL POLICY

OF THE JOINT ECONOMIC COMMITTEE

1. Back in 1980, supply-siders predicted that the savings rate would climb from 6 percent of disposable income in 1980 to more than 8 percent by 1984. Instead, the savings rate dropped to a mere 4.9 percent in 1983 and has only recently returned to the 6 percent level.

   Critics would charge that this destroys your argument for the supposed incentive effects of higher after-tax returns on savings.

   How do you explain the lack of growth in the rate of personal savings?

2. Back in 1981, Treasury Secretary Donald Regan said that improvements in depreciation write-offs and an increased investment tax credit would result in a large increase in business investment from 11.5 percent of gross national product to 14.5 percent in 1984. However, business investment rose less than one percentage point over the period.

   Certainly, Treasury Secretary Regan and supply-siders did not count on a recession, but the upswing in business investment over the entire period was still somewhat below your expectations. Wouldn't you agree and how do you explain it?

3. Critics of the accelerated cost-recovery system, while acknowledgeing that it may stimulate investment to some degree, argue that it is stimulating the wrong kind of investment. Critics argue that investment in short-lived equipment is favored at the expense of longer lasting equipment and structures. Barry Bosworth points out that, despite the fast growth of gross investment, net investment, that is after adjustment for the wearing out and obsolescence of the capital stock, has climbed no higher as a percentage of GNP than it did in the 1975 recovery. In other words, it appears that companies have been buying equipment that either quickly wears out or quickly becomes obsolete. How do you explain the fact that business appears to be investing more but total plant and equipment is growing no faster than it did in the 1970's? Doesn't this heavy investment in short-lived assets potentially undermine future U.S. competitiveness?

4. Donald W. Kiefer, the Congressional Research Service's tax policy analyst, concluded in a report that studying the published tax return data for 1982 neither proves nor disproves the supply-siders' claim that the Economic Recovery Act of 1981 induced upper income taxpayers to rely less heavily on tax shelters and to pay more, not less, income tax because the tax data do not enable separating out a number of important effects.

   I plan to place in the Record the introduction and summary of Mr. Kiefer's study, and I would appreciate your replying to it for the Record.

5. I am one of those who feels that there are substantial risks associated with the current situation of sky-high budget deficits, the high interest rates, and the dependence on continued import of capital.

   Clearly, capital imports in the past few years have served as an important safety valve that relieves the pressure of public-sector deficits on investment activity. But, I believe there are also limits to the volume of capital that can be imported, and there is some indication that the overly strong dollar position is weakening. I would like your comments on the implications of continued budget deficits, high value of the U.S. dollar in world markets, and the continued dependency of the United States on capital imports.

6. Many supply-siders seem to feel that economic growth will eventually shrink the budget deficit. What if this view is wrong and a serious recession does occur between now and the end of the decade? Wouldn't the present large structural budget deficit suffer another astronomical increase and what would be the consequences for monetary policy, fiscal policy, and the future of the American economy?

7. What evidence do you have that work effort has increased especially for high-income individuals?

8. What direct evidence do you have that tax avoidance and the use of tax shelters have declined?

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THE 1982 TAX RETURN DATA AND SUPPLY-SIDE RESPONS
MANIFESTATION OR MIRAGE?

Donald W. Kiefer
Specialist in Public Finance
Economics Division
July 31, 1984

THE 1982 TAX RETURN DATA AND SUPPLY-SIDE RESPONSE TO THE TAX CUT: MANIFESTATION OR MIRAGE?

INTRODUCTION AND SUMMARY

Recently, a series of well-publicized claims has been made that preliminary data from the 1982 individual income tax returns verify the supply-side arguments regarding the expected effects of the tax cut included in the Economic Recovery Tax Act of 1981 (ERTA). The claims have pointed out that in 1982, the first year during which a portion of the tax cut was in effect for the full year, taxpayers in upper-income brackets paid a larger proportion of total income taxes than in 1981, and also paid more taxes in absolute terms than in 1981, despite the tax cut. These observations are claimed to show that the tax cut induced upper-income taxpayers to rely less heavily on tax shelters, and that the distribution of the tax cut was not unfair, as some have criticized, because the upper-income taxpayers are paying more tax, not less.

This paper examines these claims. Theoretically, it is correct that a reduction in marginal tax rates should induce less reliance on tax shelters and other tax-favored activities. The strength of this response to the ERTA tax cut is, however, open to question. It is also questionable whether the published tax data shed any light on this issue. The implications regarding the fairness or equity issue are more clear, but require concentration on the effects of the tax cut on the distribution of income, not simply on tax payments.

The principal points made in the analysis may be summarized as follows:

- The published tax return data are not well suited to studying the responses of taxpayers to tax policy changes because the data do not report a comprehensive income measure, and they do not permit observing the circumstances of individual taxpayers, or even the same group of taxpayers, from one year to the next.

- Higher total tax payments in an income bracket in 1982 than in 1981 occurred only in the $40,000 to $50,000 income bracket and in brackets above $150,000. Thus, the income level above which returns in all brackets paid higher taxes in 1982 than 1981 is $150,000; the brackets above this income contained only 0.3 percent of all tax returns in 1982.

- The higher total tax payments in the high-income brackets are attributable to the fact that in 1982 there were more returns in these brackets than in 1981. An increasing number of returns in upper-income brackets and a decreasing number in lower-income brackets is a natural consequence of the general growth in income. Furthermore, the tax return data provide evidence of substantial tax planning activities (acceleration of deductions to 1981 and deferral of income to 1982) at the highest income levels, which distort the 1981 and 1982 data. There is no way, using the tax return data, to identify separately the effects of these influences versus the supply-side effects. Thus, the published tax return data can be used neither to prove nor disprove the existence of significant supply-side responses to the tax cut.

- The tax planning activities apparent in the highest-income brackets make a comparison of 1981 and 1982 tax data misleading regarding both tax payments and the size of the tax cut. When the tax cut is measured as the change in effective tax rates from 1980, prior to any effects of the tax cut, to 1982, the magnitude of the tax cut is consistent with the projections made at the time of its passage. That is, contrary to some recent claims, the tax cut is largest in the highest-income brackets.

- The published tax return data are also not well suited to studying the distributional effects of tax policy, both because they do not report a comprehensive income measure and they do not report any information regarding people who do not file income tax returns. If the data are used for this purpose, however, they indicate both that the distribution of income was more unequal and that the income tax had a smaller effect in reducing inequality after the tax cut than before, which seems inconsistent with the claim that the tax cut increased the equity of the tax system. Taking into account the possible supply-side effects of the tax cut in the highest-income brackets makes the tax cut appear less

progressive, not more so. On the other hand, examining tax progressivity from this perspective focuses attention on the equity/efficiency trade-off involved in progressive taxation. If there are significant supply-side responses to higher marginal tax rates, then more progressive taxation and greater income equality are achieved at the cost of reduced aggregate income and output. The 1982 tax return data, however, do not shed much additional light on the nature of this trade-off.

The Florida State University
Tallahassee, Florida 32306

Policy Sciences Program

May 13, 1985

Senator William Proxmire
Congress of the United States
Washington, D.C. 20510

Dear Senator Proxmire:

A copy of my response to your questions with regard to my April 23 testimony before the Joint Economic Committee is enclosed. Since I am a long time admirer of your insight on economic matters, it was particularly a pleasure to respond to your request. I, too, was disappointed that you were unable to attend the formal hearing. Perhaps our paths will cross in the future.

I am also enclosing three papers that relate to the issues you raise. From a policy standpoint, three themes run through these papers. First, high marginal tax rates distort work, investment, and consumption choices in a manner that reduces our economic efficiency. Influenced by tax considerations, workers and investors in high tax brackets often apply their energies to projects which generate little social value — the underground economy, businesses designed with an eye to tax deductibility of goods providing personal consumption benefits, and investments designed to yield accounting losses (tax shelter benefits). Similarly, high marginal tax rates make deductible expenditures cheap for persons confronting the high rates. Thus, taxpayers are often induced to consume deductible goods which they value less than the production costs. These forces are pervasive and beyond the reach of any regulatory policy (loophole closing strategy) consistent with a free society. The perverse incentive structure emanating from the high marginal rates squanders resources and reduces our rate of economic growth. The basic problem is efficiency, not work effort. Studies showing that tax rates exert little impact on the hours worked (of primary workers) or savings rates fail to comprehend the nature of the problem. It is not so much that productive Americans work less, but rather that they work at the wrong things.

Second, these forces are far more important in upper than lower tax brackets because the difference between the personal and social benefits (or cost) emanating from taxes is greatest in the upper brackets. Thus, the tax base is considerably more responsive in the upper brackets to changes in marginal tax rates. For high rates, say combined federal and state rates in excess of 50 percent, the supply-side view that lower tax rates promote more efficient use of resources and lead to substantial expansion in the tax base is essentially correct.

In contrast, none of my research indicates that lower rates exert much impact on the level of economic activity for marginal rates in the 30 percent range and under. To the extent that some supply-side economists have argued that lower rates in this range result in significant expansion in the tax base, I believe their analysis is incorrect.

Third, I believe the egalitarian impact of progressive tax rates is highly exaggerated. This is an important point since the distributional issue is always raised by those opposing reductions in the top marginal rates. The reasons why progressive rates exert little egalitarian impact are outlined in detail in the enclosed paper of James Long and myself "Is the Flat Tax a Radical Idea?" (pp. 9-22). I will summarize them briefly. Annual income is a poor measure of economic status because of lifecycle factors, cost-of-living differences among locations, size of family variations, and differences in the availability of nonmarket time. Given the size of tax shelter activities, taxable annual income is a still less accurate measure of economic status. Given the inaccuracy of annual taxable income as a measure of economic status, the high rates are often imposed on the wrong people and much of the redistribution is among families of similar economic status. To the extent progressive rates do tax certain activities more heavily, they lower after tax returns. With the passage of time, the lower returns will reduce supply and lead to an increase in before tax returns. Thus, the alleged egalitarian redistributive effects are more imaginary than real.

Finally, my research is supportive of tax policies such as Bradley-Gephardt, Kemp-Kasten, and hopefully the revised Treasury plan which reduce the top marginal rates. I believe that the current high rates are a major obstacle to the efficient use of resources. I encourage you to work hard for a sensible tax bill that will get the top marginal rates down.

If you have additional questions or desire clarification in any area, please feel free to contact me in the future.

Best wishes,

James Gwartney
Professor of Economics
and Policy Sciences

Responses of James Gwartney To Questions Submitted
by Senator William Proxmire

1. Back in 1980, supply-siders predicted that the savings rate would climb from 6 percent of disposable income in 1980 to more than 8 percent by 1984. Instead, the savings rate dropped to a mere 4.9 percent in 1983 and has only recently returned to the 6 percent level. Critics would charge that this destroys your argument for the supposed incentive effects of higher after-tax returns on savings. How do you explain the lack of growth in the rate of personal savings?

As this committee is aware, savings is a residual which is very difficult to measure. It is clear that current measurement methods are highly misleading because they fail to account for increases in wealth (a form of savings) due to increases in the real value of capital assets. In order to illustrate the importance of this factor, consider two economies A and B, each with an initial national income of $100 billion, a net savings rate of 5 percent, and capital assets valued at $1.0 trillion. Suppose economy A increases its net savings from $5 billion to $7 billion and thereby adds an addition $7 billion to the value of its capital stock. In contrast, suppose the measured flow of net savings of economy B remains at $5 billion, but the value of B's previous capital stock rises from 1.0 to 1.002 trillion, a $2 billion increase. When coupled with the $5 billion additional flow of net savings and investment, the capital stock of economy B also increases by $7 billion even though its measured savings rates remained constant. The savings of economy B, which took the form of increases in the value of existing capital, were not counted even though they contributed to the wealth of the nation just as much as the increases in the measured flow of savings.

This simple examples illustrates what happened in the United States following the 1982-1984 reduction in tax rates. At the lower rate of taxation, future taxable income streams from stocks and bonds were more valuable because of their higher after-tax yield. Their capital values rose. This increase in capital value was just as much an addition to personal wealth as an increase in one's personal savings account. Yet our method of national accounting fails to count the former as savings.

Once one considers the increases in personal wealth associated with the stock and bond market boom of 1982-1983, it is clear that the personal savings rate was quite high during the period. But since it took the form of an increase in the value of capital assets, our national income accounts which focus on "flows" rather than "stocks," failed to register this important source of personal savings (additions to wealth).

2. Back in 1981, Treasury Secretary Donald Regan said that improvements in depreciation write-offs and an increased investment tax credit would result in a large increase in business investment from 11.5 percent of gross national product to 14.5 percent in 1984. However, business investment rose less than one percentage point over the period. Certainly, Treasury Secretary Regan and supply-siders did not count on a recession, but the upswing in business investment over the entire period was still somewhat below your expectations. Wouldn't you agree and how do you explain it?

It is important to distinguish between (a) industrial policy supply-side economists and (b) resource efficiency supply-side economists. The industrial policy supply-siders believe that tax breaks for capital formation and other specially targeted subsidies for allegedly high growth projects are the keys to rapid economic growth. I reject this view. I do not believe that either a group of economic experts or political decision-makers allocating other people's (taxpayer's) money will pick winners and thereby promote economic efficiency and growth. Quite the contrary, I believe allocation via this process will squander resources and lead to stagnation.

However, along with other resource efficiency supply-side economists, I believe that individuals and businesses will contribute more to the productive process and use resources more efficiently (a) when they are better able to capture the benefits of helping others in exchange for income and (b) when they more fully bear the cost of the scarce resources that they use. Lower marginal tax rates are a move in that direction. In contrast, higher marginal tax rates limit the ability of decisionmakers to capture the benefits of the good things they do for others. Thus, individuals supply fewer productive activities which generate taxable income. Simultaneously, high marginal rates permit individuals to gain from tax deductible business and personal expenditures while bearing only a fraction of the actual costs. Since the personal costs of deductible expenditures are cheap, decisionmakers choose such items even when they are not valued very highly. The result is inefficiency.

Resource efficiency supply-siders recognize that like other resources, capital can be misallocated. High capital formation does not necessarily mean economic growth. For example, during the last two decades the United Kingdom has invested a larger share of its GNP than the United States. However, the growth rate of the U.S. has exceeded that of the U.K. because we have used our resources, including capital, more efficiently.

For the resource efficiency supply-side economist, economic growth rather than capital formation is the test of success. As Exhibit 7 of my testimony points out, the U.S. economic growth record following the tax cut has been quite impressive. Even while decelerating the inflation rate more rapidly than other industrial nations, our economy has grown more rapidly than any other major western nation.

One final point — when isolating the impact of tax policy on capital formation, one should focus on the growth of real investment, not investment as a proportion of GNP. After all, the Investment/GNP rate may change little even though both real investment and real GNP are growing rapidly. Judged by the standard of growth in real investment, the 1981 tax legislation was highly successful. Since plant capacity is abundant during a recession, investment usually lags well behind the growth of income during the first year of a recovery. But this was not the case during the recovery of 1983. Real gross private investment expanded at an annual rate of 40.3 percent from 1982(4) to 1983(4). During the 9 quarters following 1982(4), real private investment increased at an annual rate of 25.3 percent. By way of comparison, real consumption grew at an annual rate of 4.9 percent during the same time period. These figures are hardly indicative of a weakness in investment following the tax cut.

3. Critics of the accelerated cost-recovery system, while acknowledging that it may stimulate investment to some degree, argue that it is stimulating the wrong kind of investment. Critics argue that investment in short-lived equipment is favored at the expense of longer lasting equipment and structures. Barry Bosworth points out that, despite the fast growing of gross investment, net investment, that is after adjustment for the wearing out and obsolescence of the capital stock, has climbed no higher as a percentage of GNP than it did in 1975 recovery. In other words, it appears that companies have been buying equipment that either quickly wears out or quickly becomes obsolete. How do you explain the fact that business appears to be investing more but total plant and equipment is growing no faster than it did in the 1970's? Doesn't this heavy investment in short-lived assets potentially undermine future U.S. competitiveness?

As I previously indicated, it is easy to over emphasize the importance of capital formation as a source of economic growth. However, the problem alluded to in this question is more imaginary than real. Net investment has grown less rapidly than gross investment precisely because ACRS leads to a more rapid "paper write-off" for depreciation. The accounting method makes it appear that machines are wearing out more rapidly since the depreciation write-off has been accelerated. But this is strictly an accounting phenomenon. I am unaware of any evidence, based on comparable accounting practices, that suggests U.S. businesses are acquiring less durable equipment during the post tax cut period.

4. Donald W. Kiefer, the Congressional Research Service's tax policy analyst, concluded in a report that studying the published tax return data for 1982 neither proves nor disproves the supply-siders' claim that the Economic Recovery Act of 1981 induced upper income taxpayers to rely less heavily on tax shelters and to pay more, not less, income tax because the tax data do not enable separating out a number of important effects. I plan to place in the Record the introduction and summary of Mr. Kiefer's study, and I would appreciate your replying to it for the Record.

Mr. Kiefer's point that the 1982 data alone do not provide solid evidence as to the greater responsiveness of the tax base to lower tax rates in the upper tax brackets is correct. However, taken in conjunction with other evidence the 1982-83 data are persuasive with regard to this point. Prior to 1981, we had previously experienced two major income tax rate reductions. On both occasions, the lower rates were associated with rapid expansion in the taxable income base in the upper brackets. As a result, the share of the tax liability shouldered by upper income taxpayers rose. For example, as the top rate was slashed from 73 percent in 1921 to only 25 percent in 1926, both the real dollar and relative share of taxes collected from high income taxpayers rose. Similarly, in the two years following the 1964-1965 rate reductions, tax revenue collected from the top 5 percent of earners rose by 7.7 percent, while the tax liability of all other income groups fell.

In addition, the recent work of James Long of Auburn University and myself on the linkage between marginal tax rates and the taxable income base in 1979 also found the tax base to be more sensitive to rate changes in the upper brackets. In fact, our analysis suggests that combined state-federal marginal tax rates above 50 percent actually reduce tax revenue collected from high income taxpayers in the long run. Since the methodology of the study was entirely different from time series comparison studies, we believe that the findings are of particular importance.

The bottom line is that economic theory, the experience of three tax cuts, and detailed analysis of individual tax data all indicate that the tax base expands when the top marginal rates are reduced. This is not an unorthodox proposition. It is a reflection of the basic postulate of economics. For the life of me, I cannot understand why so many perfectly intelligent people find it difficult to comprehend.

One final point relating to Kiefer's work. He correctly notes that there were more high income taxpayers in 1982 (and 1983) than for earlier years. Some researchers have carelessly used data grouped by nominal income categories to argue that more tax revenues were collected from the rich. However, my analysis is for percentile groupings. In effects, it adjusts for shifts in the number of taxpayers among nominal income groupings. Thus, it does not suffer from the defect to which Kiefer alludes. Nonetheless, the data indicate that high income taxpayer shouldered a larger share of the income tax burden in 1983 than they shouldered during prior years (see Exhibits 1, 2, and 3 of prepared statement).

5. I am one of those who feels that there are substantial risks associated with the current situation of sky-high budget deficits, the high interest rates, and the dependence on continued import of capital. Clearly, capital imports in the past few years have served as an important safety valve that relieves the pressure of public-sector deficits on investment activity. But, I believe there are also limits to the volume of capital that can be imported, and there is some indication that the overly strong dollar position is weakening. I would like your comments on the implications of continued budget deficits, high value of the U.S. dollar in world markets, and the continued dependency of the United States on capital imports.

The linkage between budget deficits and real interest rates is a complex one. Even the theoretical linkage is dependent upon rejection of the propositions that deficits induce individuals to (a) save for the expected higher future tax liablility (to meet the larger interest payments on the deficits) and (b) make larger intergenerational transfers to their heirs. As the debate among economists indicates, it is not obvious that these propositions are incorrect.

Honesty compels me to reply that I do not know the extent, if at all, that budget deficits push up interest rates. My own view is that deficits do place upward pressure on interest rates although probably not as much as is widely believed. Nonetheless, I must confess that the most comprehensive study of which I am aware concludes that historically deficits have not caused rising real interest rates. This study, conducted by Paul Evans of the University of Houston, was recently published in the March 1985 issue of the Ameican Economic Review. Evans concludes:

> Economists like to think of economics as a science. In a science, however, repeated contradictions of a paradignm lead to its abandonment if there is any sensible alternative. One paradigm in economics implies that large deficits produce high interest rates. This paradigm is not supported by the facts. In over a century of U.S. history, large deficits have never been associated with high interest rates.

The interest rate/deficit linkage aside, I belief that it is important to reduce the size of the U.S. budget deficit. In my judgment, we would get a more efficient allocation of government expenditures if the federal budget was balanced. Thus, I support institutional arrangements that will lead to a balanced budget.

6. Many supply-siders seem to feel that economic growth will eventually shrink the budget deficit. What if this view is wrong and a serious recession does occur between now and the end of the decade? Wouldn't the present large structural budget deficit suffer another astronomical increase and what would be the consequences for monetary policy, fiscal policy, and the future of the American economy?

I do not believe that either economic growth or higher taxes will substantially shrink the deficit. Fundamental reforms such as the balanced-budget amendment, line-item veto, and a supra majority (e.g. two-third) for the passage of requirement appropriations will be necessary if we are to return to a consistent balance between federal revenues and expenditures.

7. What evidence do you have that work effort has increased especially for high-income individuals?

8. What direct evidence do you have that tax avoidance and the use of tax shelters have declined?

These questions were both dealt with in considerable detail in my prepared statement (see pp. 12-20). In particular, the rapid increase between 1981 and 1983 in the net income of high income taxpayers from the sources (business, professional, and partnership income) most influenced by tax shelter activities indicates a reduction in tax shelter activities. The rapid growth of the salary and wage income of high income taxpayers suggests a shift away from non-taxed methods of compensation toward taxable forms of compensation (see Exhibit 4). In addition, major marketers of tax shelter investments are now reporting sharp declines in sales. Several business news publications including Time and The Wall Street Journal have recently run features on this topic. Given the time period required to adjust one's portifolio, the shift away from tax shelters toward investments yielding taxable returns is unfolding precisely as expected (see pp. 19-20 of my prepared statement).

Response of Richard K. Vedder to Written Questions Posed by Senator Proxmire

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Congress of the United States
JOINT ECONOMIC COMMITTEE
(CREATED PURSUANT TO SEC. 5(a) OF PUBLIC LAW 304, 79TH CONGRESS)
Washington, DC 20510

April 30, 1985

Dr. Richard Vedder
Department of Economics
Ohio University
Copeland Hall
Athens, Ohio 45701

Dear Dr. Vedder:

I was not able to attend the April 23, 1985, hearing before the Subcommittee on Monetary and Fiscal Policy during which you testified on the hearing topic of "Tax Reform, Tax Rates, and Tax Revenues." I do have some questions that I would appreciate your answering for the hearing record, including some specific questions on the tax issues raised during the hearing and some more general questions on supply-side economics. The questions are attached.

You may submit your responses either with your corrected hearing transcript or directly to Mr. Ed Jacobs at the Joint Economic Committee, G-01 Dirksen Senate Office Building, Washington, D.C. 20510. I would also appreciate having a copy of your responses for my own use.

Thank you for taking the extra time to answer my questions.

Sincerely,

William Proxmire
U.S.S.

WP:rkt

Attachments

QUESTIONS SUBMITTED BY SENATOR PROXMIRE

TO WITNESSES TESTIFYING APRIL 23, 1985, BEFORE THE

SUBCOMMITTEE ON MONETARY AND FISCAL POLICY

OF THE JOINT ECONOMIC COMMITTEE

1. Back in 1980, supply-siders predicted that the savings rate would climb from 6 percent of disposable income in 1980 to more than 8 percent by 1984. Instead, the savings rate dropped to a mere 4.9 percent in 1983 and has only recently returned to the 6 percent level.

   Critics would charge that this destroys your argument for the supposed incentive effects of higher after-tax returns on savings.

   How do you explain the lack of growth in the rate of personal savings?

2. Back in 1981, Treasury Secretary Donald Regan said that improvements in depreciation write-offs and an increased investment tax credit would result in a large increase in business investment from 11.5 percent of gross national product to 14.5 percent in 1984. However, business investment rose less than one percentage point over the period.

   Certainly, Treasury Secretary Regan and supply-siders did not count on a recession, but the upswing in business investment over the entire period was still somewhat below your expectations. Wouldn't you agree and how do you explain it?

3. Critics of the accelerated cost-recovery system, while acknowledgeing that it may stimulate investment to some degree, argue that it is stimulating the wrong kind of investment. Critics argue that investment in short-lived equipment is favored at the expense of longer lasting equipment and structures. Barry Bosworth points out that, despite the fast growth of gross investment, net investment, that is after adjustment for the wearing out and obsolescence of the capital stock, has climbed no higher as a percentage of GNP than it did in the 1975 recovery. In other words, it appears that companies have been buying equipment that either quickly wears out or quickly becomes obsolete. How do you explain the fact that business appears to be investing more but total plant and equipment is growing no faster than it did in the 1970's? Doesn't this heavy investment in short-lived assets potentially undermine future U.S. competitiveness?

4. Donald W. Kiefer, the Congressional Research Service's tax policy analyst, concluded in a report that studying the published tax return data for 1982 neither proves nor disproves the supply-siders' claim that the Economic Recovery Act of 1981 induced upper income taxpayers to rely less heavily on tax shelters and to pay more, not less, income tax because the tax data do not enable separating out a number of important effects.

   I plan to place in the Record the introduction and summary of Mr. Kiefer's study, and I would appreciate your replying to it for the Record.

5. I am one of those who feels that there are substantial risks associated with the current situation of sky-high budget deficits, the high interest rates, and the dependence on continued import of capital.

   Clearly, capital imports in the past few years have served as an important safety valve that relieves the pressure of public-sector deficits on investment activity. But, I believe there are also limits to the volume of capital that can be imported, and there is some indication that the overly strong dollar position is weakening. I would like your comments on the implications of continued budget deficits, high value of the U.S. dollar in world markets, and the continued dependency of the United States on capital imports.

6. Many supply-siders seem to feel that economic growth will eventually shrink the budget deficit. What if this view is wrong and a serious recession does occur between now and the end of the decade? Wouldn't the present large structural budget deficit suffer another astronomical increase and what would be the consequences for monetary policy, fiscal policy, and the future of the American economy?

7. What evidence do you have that work effort has increased especially for high-income individuals?

8. What direct evidence do you have that tax avoidance and the use of tax shelters have declined?

84-702 E

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THE 1982 TAX RETURN DATA AND SUPPLY-SIDE RESPONSE: MANIFESTATION OR MIRAGE?

Donald W. Kiefer
Specialist in Public Finance
Economics Division
July 31, 1984

THE 1982 TAX RETURN DATA AND SUPPLY-SIDE RESPONSE TO THE TAX CUT: MANIFESTATION OR MIRAGE?

INTRODUCTION AND SUMMARY

Recently, a series of well-publicized claims has been made that preliminary data from the 1982 individual income tax returns verify the supply-side arguments regarding the expected effects of the tax cut included in the Economic Recovery Tax Act of 1981 (ERTA). The claims have pointed out that in 1982, the first year during which a portion of the tax cut was in effect for the full year, taxpayers in upper-income brackets paid a larger proportion of total income taxes than in 1981, and also paid more taxes in absolute terms than in 1981, despite the tax cut. These observations are claimed to show that the tax cut induced upper-income taxpayers to rely less heavily on tax shelters, and that the distribution of the tax cut was not unfair, as some have criticized, because the upper-income taxpayers are paying more tax, not less.

This paper examines these claims. Theoretically, it is correct that a reduction in marginal tax rates should induce less reliance on tax shelters and other tax-favored activities. The strength of this response to the ERTA tax cut is, however, open to question. It is also questionable whether the published tax data shed any light on this issue. The implications regarding the fairness or equity issue are more clear, but require concentration on the effects of the tax cut on the distribution of income, not simply on tax payments.

The principal points made in the analysis may be summarized as follows:

- The published tax return data are not well suited to studying the responses of taxpayers to tax policy changes because the data do not report a comprehensive income measure, and they do not permit observing the circumstances of individual taxpayers, or even the same group of taxpayers, from one year to the next.

- Higher total tax payments in an income bracket in 1982 than in 1981 occurred only in the $40,000 to $50,000 income bracket and in brackets above $150,000. Thus, the income level above which returns in all brackets paid higher taxes in 1982 than 1981 is $150,000; the brackets above this income contained only 0.3 percent of all tax returns in 1982.

- The higher total tax payments in the high-income brackets are attributable to the fact that in 1982 there were more returns in these brackets than in 1981. An increasing number of returns in upper-income brackets and a decreasing number in lower-income brackets is a natural consequence of the general growth in income. Furthermore, the tax return data provide evidence of substantial tax planning activities (acceleration of deductions to 1981 and deferral of income to 1982) at the highest income levels, which distort the 1981 and 1982 data. There is no way, using the tax return data, to identify separately the effects of these influences versus the supply-side effects. Thus, the published tax return data can be used neither to prove nor disprove the existence of significant supply-side responses to the tax cut.

- The tax planning activities apparent in the highest-income brackets make a comparison of 1981 and 1982 tax data misleading regarding both tax payments and the size of the tax cut. When the tax cut is measured as the change in effective tax rates from 1980, prior to any effects of the tax cut, to 1982, the magnitude of the tax cut is consistent with the projections made at the time of its passage. That is, contrary to some recent claims, the tax cut is largest in the highest-income brackets.

- The published tax return data are also not well suited to studying the distributional effects of tax policy, both because they do not report a comprehensive income measure and they do not report any information regarding people who do not file income tax returns. If the data are used for this purpose, however, they indicate both that the distribution of income was more unequal and that the income tax had a smaller effect in reducing inequality after the tax cut than before, which seems inconsistent with the claim that the tax cut increased the equity of the tax system. Taking into account the possible supply-side effects of the tax cut in the highest-income brackets makes the tax cut appear less

progressive, not more so. On the other hand, examining tax progressivity from this perspective focuses attention on the equity/efficiency trade-off involved in progressive taxation. If there are significant supply-side responses to higher marginal tax rates, then more progressive taxation and greater income equality are achieved at the cost of reduced aggregate income and output. The 1982 tax return data, however, do not shed much additional light on the nature of this trade-off.

Response of Richard K. Vedder to Written
Questions Posed by Senator Proxmire

I, too, was disappointed that you, Senator Proxmire, were unable to attend the Joint Economic Committee Hearing on April 23, 1985. I think you would found it informative. I am pleased, however, to have this opportunity to respond to your concerns.

QUESTION #1 -Savings Rate

First, the inference that I was among those that argued that the tax cut would increase the savings rate is incorrect; at no time or place did I ever predict a sharp rise in personal savings. Second, I am less confident then you that the savings rate has failed to grow, since the statistics on savings are the least reliable of any in the national income accounts, since it is essentially treated as a residual. Federal Reserve flow of funds data, for example, provide a somewhat different picture than Commerce Department numbers. All of this, though, is besides the point. The relevant savings rate is the overall rate of private sector savings. A quick examination at, say, the Economic Report of the President, reveals that private savings have exploded since 1980. See p. 262 of the latest Report : private savings rose from $435 to $675 billion from 1980 to 1984, an increase of 55 percent (24 percent in real terms). By contrast, from 1976 to 1980, real private savings rose less than 10 percent, less than half as much.

QUESTIONS #2 -#3 Investment

I never supported expanding the investment tax credit and am somewhat uneasy over parts of ACRS. Nonetheless, I cannot agree with the implications of your questions that investment has grown sluggishly in recent years. See p.234 of the latest Economic Report. Real gross private domestic investment in 1984 was 40 percent above 1980, three times the growth observed from 1976 to 1980. The near 50 percent growth in that measure from 1982 to 1984 is about as robust as observed at any time in modern American economic

history. I would agree that too much of the growth may be in structures, possibly reflecting a tax-induced bias. In the interest of neutrality, that bias should be corrected.

QUESTION #4 - Kiefer Article

I was frankly somewhat appalled that you asked about the Kiefer article, and even introduced it into the record. Mr. Kiefer formulated a plausible hypothesis about the increase in tax revenues from "the rich" in 1982, but a hypothesis that is completely at variance with the facts. The Joint Economic Committee itself has taken the lead on this issue, and I commend to you a study published on October 26, 1984 that speaks to this point , especially pages 8 and 15-17 ("Tax Avoidance, Tax Equity, and Tax Revenues...") Any doubt about the Kiefer effect was erased with the release of the 1983 preliminary income tax data, as my colleague Lowell Gallaway and I pointed out in the Wall Street Journal on March 21.

QUESTIONS #5-6 - Deficits

I simply do not understand all of the hysteria over the budget deficit. To be sure, the deficit has resulted from a surge in government spending that in some ultimate sense should crowd out private activity, which I view with some alarm. But the notion that the deficit has pushed up interest rates simply is not supported by evidence. Examining over 100 years of American history, Paul Evans in the March 1985 issue of the American Economic Review found no evidence that budget deficits increase interest rates - indeed they may lower them. Regarding the foreign sector, we should rejoice that we have been able to send foreigners little pieces of green paper with funny looking men on them in exchange for practical things of value that enrichen our lives, like autos and electronic gadgets. To be sure, we may not be able to con them into continuing this forever, but while we can, let us enjoy.

QUESTIONS #7-8 Behavior of the Rich

On the work effort and tax sheltering of upper income Americans, I would refer you to the aforementioned October 26 JEC study, and to articles by Prof. Gallaway and I in the Wall Street Journal on March 21 and May 8. I would add that I have been examining the behavior of upper income Americans throughout the history of the individual income tax; the evidence supports the hypothesis that tax sheltering and work effort are systematically and strongly correlated with marginal income tax rates. An examination of, say, partnership income, for recent years shows that marginal tax rate reductions have the effect of reducing the relative attractiveness of shelters.

I appreciate this opportunity to extend my remarks to the Committee on this issue of importance to the Nation.

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Response of Paul Craig Roberts to Written Questions Posed by Senator Proxmire

Congress of the United States
JOINT ECONOMIC COMMITTEE
Washington, DC 20510

April 30, 1985

Dr. Paul Craig Roberts
Center for Strategic and International Studies
Georgetown University
1800 K Street, N.W., Suite 400
Washington, D.C. 20006

Dear Dr. Roberts:

I was not able to attend the April 23, 1985, hearing before the Subcommittee on Monetary and Fiscal Policy during which you testified on the hearing topic of "Tax Reform, Tax Rates, and Tax Revenues." I do have some questions that I would appreciate your answering for the hearing record, including some specific questions on the tax issues raised during the hearing and some more general questions on supply-side economics. The questions are attached.

You may submit your responses either with your corrected hearing transcript or directly to Mr. Ed Jacobs at the Joint Economic Committee, G-01 Dirksen Senate Office Building, Washington, D.C. 20510. I would also appreciate having a copy of your responses for my own use.

Thank you for taking the extra time to answer my questions.

Sincerely,

William Proxmire
U.S.S.

WP:rkt

Attachments

QUESTIONS SUBMITTED BY SENATOR PROXMIRE

TO WITNESSES TESTIFYING APRIL 23, 1985, BEFORE THE

SUBCOMMITTEE ON MONETARY AND FISCAL POLICY

OF THE JOINT ECONOMIC COMMITTEE

1. Back in 1980, supply-siders predicted that the savings rate would climb from 6 percent of disposable income in 1980 to more than 8 percent by 1984. Instead, the savings rate dropped to a mere 4.9 percent in 1983 and has only recently returned to the 6 percent level.

   Critics would charge that this destroys your argument for the supposed incentive effects of higher after-tax returns on savings.

   How do you explain the lack of growth in the rate of personal savings?

2. Back in 1981, Treasury Secretary Donald Regan said that improvements in depreciation write-offs and an increased investment tax credit would result in a large increase in business investment from 11.5 percent of gross national product to 14.5 percent in 1984. However, business investment rose less than one percentage point over the period.

   Certainly, Treasury Secretary Regan and supply-siders did not count on a recession, but the upswing in business investment over the entire period was still somewhat below your expectations. Wouldn't you agree and how do you explain it?

3. Critics of the accelerated cost-recovery system, while acknowledgeing that it may stimulate investment to some degree, argue that it is stimulating the wrong kind of investment. Critics argue that investment in short-lived equipment is favored at the expense of longer lasting equipment and structures. Barry Bosworth points out that, despite the fast growth of gross investment, net investment, that is after adjustment for the wearing out and obsolescence of the capital stock, has climbed no higher as a percentage of GNP than it did in the 1975 recovery. In other words, it appears that companies have been buying equipment that either quickly wears out or quickly becomes obsolete. How do you explain the fact that business appears to be investing more but total plant and equipment is growing no faster than it did in the 1970's? Doesn't this heavy investment in short-lived assets potentially undermine future U.S. competitiveness?

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   I plan to place in the Record the introduction and summary of Mr. Kiefer's study, and I would appreciate your replying to it for the Record.

5. I am one of those who feels that there are substantial risks associated with the current situation of sky-high budget deficits, the high interest rates, and the dependence on continued import of capital.

   Clearly, capital imports in the past few years have served as an important safety valve that relieves the pressure of public-sector deficits on investment activity. But, I believe there are also limits to the volume of capital that can be imported, and there is some indication that the overly strong dollar position is weakening. I would like your comments on the implications of continued budget deficits, high value of the U.S. dollar in world markets, and the continued dependency of the United States on capital imports.

6. Many supply-siders seem to feel that economic growth will eventually shrink the budget deficit. What if this view is wrong and a serious recession does occur between now and the end of the decade? Wouldn't the present large structural budget deficit suffer another astronomical increase and what would be the consequences for monetary policy, fiscal policy, and the future of the American economy?

7. What evidence do you have that work effort has increased especially for high-income individuals?

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THE 1982 TAX RETURN DATA AND SUPPLY-SIDE RESPONSE: MANIFESTATION OR MIRAGE?

Donald W. Kiefer
Specialist in Public Finance
Economics Division
July 31, 1984

THE 1982 TAX RETURN DATA AND SUPPLY-SIDE RESPONSE TO THE TAX CUT: MANIFESTATION OR MIRAGE?

INTRODUCTION AND SUMMARY

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This paper examines these claims. Theoretically, it is correct that a reduction in marginal tax rates should induce less reliance on tax shelters and other tax-favored activities. The strength of this response to the ERTA tax cut is, however, open to question. It is also questionable whether the published tax data shed any light on this issue. The implications regarding the fairness or equity issue are more clear, but require concentration on the effects of the tax cut on the distribution of income, not simply on tax payments.

The principal points made in the analysis may be summarized as follows:

- The published tax return data are not well suited to studying the responses of taxpayers to tax policy changes because the data do not report a comprehensive income measure, and they do not permit observing the circumstances of individual taxpayers, or even the same group of taxpayers, from one year to the next.

- Higher total tax payments in an income bracket in 1982 than in 1981 occurred only in the $40,000 to $50,000 income bracket and in brackets above $150,000. Thus, the income level above which returns in all brackets paid higher taxes in 1982 than 1981 is $150,000; the brackets above this income contained only 0.3 percent of all tax returns in 1982.

- The higher total tax payments in the high-income brackets are attributable to the fact that in 1982 there were more returns in these brackets than in 1981. An increasing number of returns in upper-income brackets and a decreasing number in lower-income brackets is a natural consequence of the general growth in income. Furthermore, the tax return data provide evidence of substantial tax planning activities (acceleration of deductions to 1981 and deferral of income to 1982) at the highest income levels, which distort the 1981 and 1982 data. There is no way, using the tax return data, to identify separately the effects of these influences versus the supply-side effects. Thus, the published tax return data can be used neither to prove nor disprove the existence of significant supply-side responses to the tax cut.

- The tax planning activities apparent in the highest-income brackets make a comparison of 1981 and 1982 tax data misleading regarding both tax payments and the size of the tax cut. When the tax cut is measured as the change in effective tax rates from 1980, prior to any effects of the tax cut, to 1982, the magnitude of the tax cut is consistent with the projections made at the time of its passage. That is, contrary to some recent claims, the tax cut is largest in the highest-income brackets.

- The published tax return data are also not well suited to studying the distributional effects of tax policy, both because they do not report a comprehensive income measure and they do not report any information regarding people who do not file income tax returns. If the data are used for this purpose, however, they indicate both that the distribution of income was more unequal and that the income tax had a smaller effect in reducing inequality after the tax cut than before, which seems inconsistent with the claim that the tax cut increased the equity of the tax system. Taking into account the possible supply-side effects of the tax cut in the highest-income brackets makes the tax cut appear less

progressive, not more so. On the other hand, examining tax progressivity from this perspective focuses attention on the equity/efficiency trade-off involved in progressive taxation. If there are significant supply-side responses to higher marginal tax rates, then more progressive taxation and greater income equality are achieved at the cost of reduced aggregate income and output. The 1982 tax return data, however, do not shed much additional light on the nature of this trade-off.

Response of Paul Craig Roberts to Written Questions Posed by Senator Proxmire

Answers to Senator Proxmire's questions for April 23, 1985 JEC hearing record.

1. Supply-side economists in the Treasury predicted that the Economic Recovery Tax Act of 1981 would raise gross private saving. As the table shows, that prediction was correct:

1950s	1960s	1970s	1980	1981	1982	1983	1984	
[illegible]	[illegible]	16.8	16.5	17.2	17.1	17.3	18.4	percent of GNP

As for the personal saving rate, most economists (not just supply-side economists) recognize that a serious recession back-to-back with a robust recovery depresses the personal saving rate. In a recession, millions are out of work and cannot save; during recovery people make deferred purchases. These effects offset the effect of lower marginal tax rates on the personal saving rate. The Kennedy tax cut of the 1960s clearly shows the effect of lower tax rates in raising the personal saving rate.

2. The 1985 Economic Report of the President (p. 30), testimony by CEA member William Niskanan and others, and U.S. Commerce Dept. data (table below) show substantial increases in investment. This occurred despite the 1982 and 1984 tax increases, which took back most of the investment incentives in the 1981 tax cut.

	Average of Five Previous Recoveries[a]	Current Recovery[b]
Real GNP—total	5.9	6.7
Consumer spending	5.3	5.8
Durables	12.9	16.0
Business fixed investment	7.3	14.1
Structures	3.5	4.8
Equipment	10.0	18.4
Residential structures	16.5	31.2
Exports	4.6	6.0
Imports	9.5	26.5
Federal purchases	−0.7	−0.8
State and local purchases	3.2	1.4
Real final sales	4.7	4.7

[a]Excluding the recovery extending into the Korean War and the short-lived 1980–81 recovery.

[b]Based on the flash estimate of 1984-II (does not include the substantial upward real GNP growth rate revisions for 1984 first and second quarters that were announced on July 23, 1984.

Source: U.S. Commerce Department.

3. Critics who are not predisposed toward the Reagan Administration sometimes forget that the reason short-lived assets show heavy investment is precisely because such assets are short-lived and wear out quickly.

4. Mr. Kiefer's conclusions were questionable last year. What does he have to say about the 1983 data and the testimony of the economists before the JEC on April 23, 1985? The IRS statistics are clear: the rich are paying a larger share. The facts are inconsistent with the irresponsible demagogy that the Reagan Administration favored the rich. Indeed, it is double demagogy considering the fact that the reduction from 70% to 50% in the first year was the work of Congressman Brodhead, a Democrat, and was not part of the Administration's original proposal.

5. As a result of erroneous statements made by the Fed chairman and by the former CEA chairman, many people have the mistaken idea that greater amounts of foreign owned capital are entering the U.S. each year, that the dollar's strength is due to these inflows, and that these inflows are financing both the trade deficit and domestic budget deficit. As the table shows, the facts are completely different.

year	1982	1983	1984
foreign owned capital inflows ($bil.)	95	82	93*
U.S. capital outflows ($ bil.)	119	49	21*

*preliminary 4th qt.

The facts are that there has been no increase in foreign capital inflows. Instead, there has been a complete collapse in U.S. capital outflows. Our capital is staying in the U.S., and we are financing our own deficit.

It is practically impossible for the U.S. to avoid trade deficits if it is the only country experiencing economic recovery. It is practically impossible for the dollar not to recover from its historic low during 1978-80 when (1) U.S. capital outflows drop $100 billion between 1982 and 1984, (2) the after-tax rate of return on real investment in the U.S. rises as a result of the 1981 tax reduction, (3) contrary to expectations, the inflation rate collapses from 12.5% to around 4%, and (4) the U.S. has the image of a firm President and a defense buildup compared to the previous appearance of vacillation.

6. There is no possibility of balancing the budget as long as the government's budget grows faster than the economy. Assuming that the 1985 spending projections do not overshoot,

federal spending will have increased 41% between 1981 and 1985. Assuming that the economic growth goal is attained in 1985, the nominal Gross National Product (inflation plus real growth) will have increased 34% between 1981 and 1985. As every economic textbook says, especially those written by Keynesian economists, a tax increase will cause the economy to grow slower. There have been several substantial tax increases since 1981, and none of them have reduced the deficit. I submit for the hearing record my article from the Sunday New York Times of May 5, 1985, which reports the facts.

It is important to also keep in mind that the large deficits are the price we have paid for the unexpected and rapid disinflation. All forecasters knew about the Reagan tax cuts, but none predicted the large deficits, because none predicted the severe recession and the collapse in the inflation rate from 12.5% in 1980 to 3.9% in 1982. The rapid disinflation has reduced nominal GNP far below projections. The Treasury table below shows that the revenue shortfall and higher interest payments due to the recession and the failure of OMB and the Congress to deliver the "unidentified spending cuts" of 1981 account for most of the increase in the deficit. Many policymakers have mistakenly assumed that the budget deficits are the result of fiscal policy, when in fact monetary policy is primarily responsible. I submit for the hearing record a paper I presented at a Cato Institute conference on the responsibility that monetary policy has for the budget deficits.

Table 3. Effect of Recession and Unidentified Spending Cuts on Deficits (billions of dollars)

	1981	1982	1983	1984	1985	1986
Deficit estimate (3/81)	54.9	45.0	22.8	+0.5	+5.8	+28.2
Revenue shortfall due to recession	3.0	34.9	87.8	105.5	110.0	119.8
Higher interest payments due to revenue shortfall	0.1	2.5	7.4	16.6	25.7	34.5
Promised spending cuts	—	—	29.8	44.2	43.7	42.7
Total effect on deficit	3.1	37.4	125.0	166.3	179.4	197.0
Deficit forecast (7/83)	58.0	110.6	209 8	200.4	205.9	219.0
Increase in deficit forecast 3/81 to 7/83	3.1	65.6	187.0	200.9	211.7	247.2
Increase in deficit due to revenue effects of recession and unidentified spending cuts	100%	57%	67%	83%	85%	80%

Source: U.S. Treasury Department.

7. There has been an increase in venture capital activity, entrepreneural activity, new business formations, and income taxes collected from the rich.

8. I have not examined this subject. By reducing tax rates and increasing the after-tax rate of return on real investment, tax shelters were made less attractive at the margin. Of course, a 50% rate is still high, and the investment incentives, especially for machinery and equipment, have been rolled back.

   It is probably the case that many people have a distorted picture of tax shelters. A few people no doubt do very well with them, but in most cases shelters do not turn out to be good investments. Often people simply lose their money instead of paying it in taxes. The government may lose the revenues, but that does not mean that the taxpayer who purchased a shelter gained any. Low tax rates tend to price shelters out of the market.

   The use of money-losing shelters is a reflection of the demoralization that heavy tax burdens cause. Consider a professional person or family earning $100,000 a year. Federal income taxes take $25,000-30,000. Add in social security taxes, state income taxes, property taxes, sales taxes, gasoline taxes, excise taxes, and other business taxes if self employed, and the earning unit has a claim to only about one-half of its earnings. What does it get from government in return for half its income? Very little of any value. At the local level chances are that the school system has been destroyed by social engineering, busing, and unionization and that the earning unit does not use the tax supported schools. The roads are probably full of potholes, because the politicians are deferring maintenance in order to buy votes with income transfers. If the earning unit has a nice car, it experiences daily the toll taken by the bad roads. It knows that the lawmakers and courts have made it difficult for the tax supported police to provide protection, and it probably views the police as just another obstacle on the daily commute. Other than once a week trash collection and, perhaps, the fire department, the earning unit probably discounts all local "services." Except for the state highways and university, the earning unit does not have even a potential relationship to state "services." On a national level, depending on the earning unit's age, it might place some value on future social security and medicare benefits, but there are no other federal services that benefit it. If intelligent, it knows that the politicians gave up national defense in the 1960s and 1970s in order to build a welfare state and that Reagan's efforts to reverse this dangerous direction have been defeated. It listens to itself described as "privileged" by politicians, who never make any reference to the hard work that went into its success, and it knows that its income that is taken by the government mainly goes to support people who have not

made similar effort to succeed. The earning unit also knows how hard and competitive the world is and truly resents the loss of the $25,000-30,000 annually that could be used to provide a cushion for its own children. Instead, the hard earned money is given to people unknown to the earning unit. It is hardly surprising that an earning unit so viciously exploited by government would prefer to lose its money in shelters than to pay it in taxes.

Addenda to the first four answers are attached.

Addenda to Dr. Roberts' answers to Senator Proxmire's questions:

1. Savings in the portfolios of individuals did increase substantially from 1980 to 1984. The rate of portfolio accumulation as measured by gross private savings rose from $435.4 billion per year in 1980 to $675.3 per year in 1984. Thus the rate of gross private savings grew by 11.6% compounded per year over the period while GNP was only growing at 8.6% per year. Some have mistakenly assumed that since the "personal savings rate" did not increase greatly that the Economic Recovery Tax Act (ERTA) did not promote savings. This ignores the fact that increases in the value of an investor's business holdings reduces the amount of other forms of savings necessary to meet desired savings. Savings in the form of increased retained business income reduces the desired amount of savings held in other instruments which would show up in the personal savings rate.

2. Gross Private Domestic Investment grew from $401.9 billion in 1980 to 637.3 in 1984. This represents a 58.6% increase in the level of investment. On an annual basis this is a compound growth of 12% per year in the level of investment while the GNP as a whole grew only a 8.6% rate from 2631.7 in 1980 to 3661.3 in 1984. Thus gross private domestic investment was growing at a rate almost 50% faster. Much of this growth is attributable to extremely rapid growth in multi-unit residential structures, one of the few categories investment goods untouched by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). TEFRA left most categories of investment goods worse-off than the ADR systems which preceeded the 1981 Act and this exacerbated the 1982 down turn while Congress debated how much to penalize business expansion.

3. Mr. Bosworth has provided an extremely flawed report of the current trends in investment. The fastest growing major investment category from 1980 to 1984 has been commercial building and multi-unit residential structures. These are extremely long lived assets which received greatly enhanced tax treatment under the Reagan Administration. The so called short-lived assets received harsher tax treatment due to the punitive features of TEFRA passed in 1982 and DEFRA passed in 1984. These acts reduced the rate of investment in equipment in general and retarded the general recovery.

As can be seen in Table 1, most equipment was subjected to a higher effective tax rate or higher capital service price. Thus, one should not expect any increase in overall equipment investment activity due to ERTA as modified by TEFRA and DEFRA. Structures, more specifically buildings, were the only unambiguous winners. However, one must be careful even here in drawing conclusions from investment data alone. The usual effective tax rate calculations usually assume constant expected inflation and zero expected relative price changes. The period

1979-1983 witnessed a significant revision in these expectations. The decline in inflation over the past 5 years has dramatically reduced inflationary expectations and thereby has decreased effective tax rates for longer lived assets. On the other hand, the decline in inflation has also curbed some of the relative price speculation that was occurring in real estate -- a phenomenon that would tend to depress investment in new buildings. Nevertheless, the data do indicate an increase in building investment ~~relative to indicate~~ a shift towards structures and away from equipment over the same period.

Our conclusions are twofold, First, there is still some confusion about the direction of effective tax rate changes due to ERTA. Some analysts persist in using the originally contemplated fully phased in ACRS tables. As is known, TEFRA and DEFRA took these benefits back and added other onerous provisions (ITC basis adjustment, minimum tax revision, etc.). Second, simple comparisons of investment growth rates, such as those by Mr. Bosworth, tell us little about the impact of tax policies on economic performance.

4. Mr. Kiefers study was undertaken before the 1983 tax return information became available. Others who earlier drew similar conclusions from the 1982 data have revised their position. The 1983 data confirm that:
   (a) The 1982 data were not simply a product of tax planning.
   (b) The trend toward higher tax payments by higher income taxpayers strengthened in 1983.
   (c) When adjusted for increased numbers of returns the 1983 data still demonstrate that the lower tax rates lead to higher tax revenues in the upper income brackets.

Table 1

Capital Service Prices Under
Alternative Depreciation Schemes

	Assets	ADR	1984 ACRS	% Change
1	Furniture and Fixtures	20.27%	20.88%	2.92%
2	Fabricated Metal Product	16.94	16.94	0.01
3	Engines and Turbines	14.76	15.14	2.49
4	Tractors	21.35	22.03	3.11
5	Agricultural Machinery Except Tractors	20.27	20.88	2.92
6	Construction Machinery Except Tractors	28.33	29.51	4.00
7	Mining and Oil Field Machinery	27.65	29.19	5.27
8	Metalworking Machinery	19.11	19.01	-0.53
9	Special Industrial Machinery	18.68	18.48	-1.06
10	General Industrial Machinery	18.32	18.26	- .35
11	Office, Computing, and Accounting Machinery	30.66	32.55	5.91
12	Service Industry Machines	19.89	20.33	2.16
13	Electrical Transmission and Distribution Equip.	16.91	17.07	.97
14	Communication Equipment	17.76	17.13	-3.67
15	Other Electrical Equipment	19.57	20.00	2.14
16	Trucks, Buses, and Truck Trailers	30.63	32.55	5.91
17	Autos	58.21	59.16	1.60
18	Aircraft	30.63	32.55	5.91
19	Ships and Boats	15.61	14.05	-11.14
20	Railroad Equipment	16.76	15.76	-6.35
21	Instruments	19.15	19.51	1.84
22	Other Equipment	20.14	20.68	2.64
23	Equipment, Total	24.60	25.16	2.25
24	Industrial Buildings	13.78	11.56	-19.20
25	Commercial Buildings	13.59	11.27	-20.56
26	Religious Buildings	13.78	11.56	-19.20
27	Educational Buildings	13.78	11.56	-19.20
28	Hospital and Institutional Buildings	13.78	11.56	-19.20
29	Other Buildings	14.12	12.13	-16.37
30	Railroad Structures	12.15	12.35	1.61
31	Telephone and Telegraph Facilities	11.78	11.54	-2.14
32	Electric Light and Power Facilities	12.45	12.86	3.18
33	Gas Facilities	12.15	12.35	1.61
34	Petroleum Pipelines	13.34	13.36	0.16
35	Farm Nonresidential Structures	12.84	10.80	-18.83
36	Petroleum and Natural Gas Explor. and Develop.	15.78	15.15	-4.13
37	Other Mining Exploration and Development	18.62	19.17	2.86
38	Other Structures	14.58	12.17	-19.80
39	Structures, Total	13.79	12.46	-10.60
	Average Across All Nonresidential Assets	20.94	20.86	-0.35

The New York Times

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A Tax Increase Would Widen the Gap

By PAUL CRAIG ROBERTS

ONCE again, David A. Stockman, the budget director, has come up with a deficit-reduction plan, this time promising reductions of $297 billion between 1986 and 1988. And once again, President Reagan and the Republican leadership have embraced the plan, even though it amounts to nothing more than a prelude to new — and counterproductive — tax increases that will ultimately insure that the budget swings even further out of balance.

Mr. Stockman's assaults on the Federal budget call to mind the World War I generals who buried their troops time and again into the machine-gun fire and barbed wire. Watching Mr. Stockman lead the Republicans in this latest assault on Social Security and other Government programs, one has to believe he is trying for the all-time record of maximum casualties with minimum results. In fact, Mr. Stockman seems determined to prove that the budget cannot be cut. This way, he can clear the way for new tax increases.

David Stockman talks a good game about bare-bones budgets, but spending continues to outpace the nation's income. This year the Federal Government will spend $50 billion more than Mr. Stockman forecast for 1985 in his 1981 budget projection. This spending increase occurred despite the numerous scale-backs in President Reagan's military-spending plans and the unexpected, rapid disinflation — both of which work to lower spending below projection.

If Federal spending this year is held within the Administration's current projection, the budget will have grown 41 percent between 1981 and 1985. If the Administration's economic growth goal is attained in 1985, nominal gross national product (inflation plus real growth) would have increased 54 percent over the same period. Real G.N.P. (measured in constant 1972 dollars) would have increased only 13 percent.

No one can balance a budget that is growing faster than the tax base, and the tax base cannot expand without faster economic growth. Despite this obvious fact, many commentators continue to assert, ignorantly, that the budget deficits are the result of the 1981 tax cuts and that the answer is higher taxes, which kill growth.

Like World War I generals, such people cannot learn from experience. There have been five tax increases since 1981, and each time the deficit has risen. In 1981, Mr. Stockman convinced President Reagan that the 1984 budget could be balanced if the Kemp-Roth tax cut was scaled down to 25 percent from 30 percent and delayed until the second half of the Presidential term. Mr. Stockman prevailed and, consequently, there was no fiscal policy to offset the Fed's restrictive monetary policy during 1981 and 1982. The economy collapsed into recession and the deficit projection quickly rose to $137 billion from $53 billion.

MR. Stockman urged a large tax increase, and in the summer of 1982, only one year after the 1981 tax cut, Mr. Reagan signed into law the largest tax increase in history, the Tax Equity and Fiscal Responsibility Act of 1982. The Treasury said that the act would raise $228 billion in new taxes between 1983 and 1987. In the summer of 1982, Mr. Stockman's figures showed that the act would reduce the deficit from $137 billion in 1983 to $69 billion in 1987. By December 1982, however, the 1983 deficit projection had jumped to $233 billion, and the 1987 estimate had increased fivefold, to $280 billion.

Despite the gasoline tax increase and higher Social Security taxes adopted on the recommendation of the Greenspan Commission on Social Security Reform, the deficit projections continued to grow. The only progress occurred in 1983, when the unexpectedly strong economic recovery reduced the five-year deficit projections by 25 percent. But the deficit was still too large and, at Mr. Stockman's urging, Mr. Reagan signed yet another tax increase in the summer of 1984. This was called the "Rose Garden down-payment plan."

According to Mr. Stockman's figures in the "Mid-Session Review of the 1985 Budget," published on Aug. 15, 1984, the down-payment plan reduced the 1985 deficit by $34 billion, the 1986 deficit by $36 billion and the 1987 deficit by $66 billion. As of last August, Mr. Stockman projected the 1985, 1986 and 1987 deficits to be $172 billion, $174 billion and $185 billion.

But, as before, the deficit went up and not down. Instead of declining by $150 billion between 1985 and 1987, the deficits came in $170 billion above Mr. Stockman's projection. By January 1985, Mr. Stockman was projecting the 1985, 1986 and 1987 deficits to be $234 billion, $230 billion and $246 billion.

During World War I the politicians could not bring themselves to dismiss the incompetent generals who piled corpse upon corpse until the nations were bled dry. The Reagan Administration cannot either, even though Republican casualties in the budget fight are mounting with the same futility.

The Administration once had a policy that favored economic growth, but the Federal Reserve has forbidden it. Consequently, the budget initiative remains with Mr. Stockman, and he is once again leading his party into the machine guns and barbed wire. ■

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THE FED'S POLICYMAKING FUNCTION: AN APPRAISAL

How the Fed Crowded Out President Reagan's Economic Policy

Paper Presented by
Paul Craig Roberts

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THE FED'S POLICYMAKING FUNCTION: AN APPRAISAL

How the Fed Crowded Out President Reagan's Economic Policy

Paul Craig Roberts

There is a fundamental problem with the Fed's policymaking function. Under the U.S. Constitution, government is not supposed to convey power without accountability. As we heard this morning from Lawrence K. Roos, who ought to know, accountability does not seem to be the case with the Federal Reserve. Perhaps this mattered less in the past when there was a gold standard and fixed exchange rates, but the advent of fiat money and flexible exchange rates have practically removed all constraints on the Fed. The result is enormous discretionary power that allows the Fed to act in self-protective ways that can crowd out the policies of an elected government.

The Fed's rogue monetary policy during 1981-82 is a good example of an unaccountable central bank acting in self-protective ways and crowding out the policies of an elected government. To a large extent, the Fed's policy, which resulted in an unexpected and severe recession and in an unexpected collapse in the inflation rate, frustrated the Reagan administration's efforts to shift the emphasis of economic policy towards greater private sector incentives and growth. The recession forced President Reagan on the defensive early in his administration, causing him to lose control of the budget while

simultaneously confronting him with the largest budget deficits in our history.

The truth starkly contrasts with the widespread belief that a courageous Fed followed a conscious gameplan and conquered inflation despite an excessively stimulatory fiscal policy. In late 1980 and early 1981 when the new administration was putting together its economic policy, there was an almost universal consensus that not very much could be done about inflation--and certainly not very quickly. The administration intended to emphasize economic growth, but it was confronted with the "Phillips curve," which argued against the prospect of real economic growth and a declining rate of inflation. At the time, forecasting models such as DRI had a "core rate of inflation" of 10 percent, which was believed to mean that 10 percent inflation was a floor even with restrictive monetary and fiscal policies.

Given the constraints of conventional thinking, a proposal from the Reagan administration to abruptly reduce inflation would have had no credibility. Moreover, many monetarists were opposed, at least in principle, to attempting an overnight cure of inflation. From their point of view, using recession to bring down inflation was pointless, because the resulting unemployment puts tremendous political pressures on the system to reflate. Monetarists wanted to break this roller coaster cycle.

In 1981 the administration's supply-side fiscal policy was a reduction in the tax burden on labor and capital. This was a disinflationary policy, because it lowered the cost of production. However, the policy was widely misinterpreted by

irresponsible economists, journalists, and politicians as a Keynesian demand stimulus coming at a time of a 12.5 percent inflation rate, a $50 billion budget deficit inherited from the Carter administration, 10 percent "core inflation," and a Phillips curve environment. All of this was following a decade of rising inflation expectations. The Fed was convinced, largely by conservative Republican economists, that inflation was going to explode and that the Fed would be blamed. The Fed responded in a self-protective way and simply turned off the money, reasoning that an administration with monetarists in office could not blame the Fed for inflation if there was no growth in the money supply. The Fed was as surprised as everyone else by the unexpected collapse in inflation and by the severe debt and liquidity problems that followed in train.

When President Reagan was inaugurated the prime rate was at a peak of 21.5 percent. These high interest rates were Reagan's legacy from Volcker's attempt to reelect President Carter by providing rapid growth in money whether measured by M1 or the St. Louis base, from July through November of 1980. The conventional wisdom was that a staunch conservative like Reagan could not be elected President, and the outpouring of money by the Fed may have caused markets to expect a continuation of the upward ratcheting of inflation. Whatever their cause, the high rates of interest, or the uncertainty that they reflected, had a negative impact on the economy.

The Reagan administration intended to deal with the situation by providing moderate, stable and predictable money growth that would first stabilize the inflation rate and then

gradually bring it down. Once markets saw that money growth and inflation were under control, interest rates would fall faster than the inflation rate due to changed expectations. The February 18, 1981, report that announced Reagan's economic program states: "the economic scenario assumes that the growth rates of money and credit are steadily reduced from the 1980 levels to one-half those levels by 1986."

The Reagan administration also intended to contribute to lower real interest rates with tax policies that would increase private sector saving and with expenditure policies that would reduce the growth rate of federal spending. From 1975 through 1980, inflation interacting with the progressive income tax and depreciation allowances had reduced private sector saving by $350-$450 billion, depending on how it is measured. During this same period federal spending had grown faster than GNP, resulting in a cumulative federal deficit of $368 billion.

Unfortunately for Reagan's economic policy and for millions of people in the economy, the Federal Reserve did not provide the moderate, stable and predictable growth of money that the central bank agreed to provide. First, the Fed allowed M1 to increase sharply from February through April, 1981, which had bad psychological effects and was taken as confirmation in many quarters that the administration intended to monetize deficits. Then the Fed slammed on the brakes and held M1 growth at about zero for six months. Before the Fed revised the data, the figures showed less money in the economy in October 1981 than in the previous April. This is a very sharp slowdown, especially

coming off the previous acceleration. All in all, in 1981 alone the Fed produced 75 percent of the total reduction in money growth that we intended to spread over a six-year period.

In 1982 the Fed repeated the pattern, allowing rapid money growth in December 1981 and January 1982 and then bringing it down to a very low rate for six months. The monetary base (St. Louis, 3-month growth rates) began decelerating in December 1980 and continued until November 1981. Velocity of money did not rise in 1981 to compensate for the decline in money growth, and in 1982 velocity fell. Unless the well-documented findings of monetarists are completely dismissed, monetary policy would seem to be a principal cause of the recession.

Turning to fiscal policy, Keynesian measures show that it was also tight in 1981. According to the Congressional Budget Office, the high employment budget showed a $7 billion surplus for 1981.[1]

Fiscal policy was depressing GNP and tax collections from a supply-side perspective as well. The delay and phase-in of the tax cuts encouraged people to shift income earning activities to the future, where tax rates were lower, and to shift tax deductions and credits to 1981 where their value was highest. The result was to worsen the economy and the deficit in 1981.

This argument is not a supply-side rationale offered after the fact of the recession. It was made prior to the election of Ronald Reagan in response to Martin Feldstein's proposal to delay any tax cuts in order to balance the budget. He argued in the summer of 1980 that the way to avoid large budget deficits as a consequence of cutting marginal rates was to enact in the present

a schedule of future tax cuts. People would begin working and investing more in anticipation of the lower tax rates, he claimed, and the growth in the tax base would generate the revenues to pay for the subsequent tax cuts.

I argued that the results would be the opposite of what Feldstein imagined.[2] Supply-side fiscal policy works by increasing the after-tax return to labor and capital. When marginal tax rates fall, both leisure and current consumption become more expensive in terms of foregone income, causing people to shift into work out of leisure and into investment out of current consumption. However, if people know that the prices of leisure and current consumption are going to rise at a future date, they could rationally decide to enjoy both while they are still cheap, just as consumers purchase commodities in anticipation of future price increases.

My argument was theoretical, but it was validated by the practical advice that accounting firms and tax lawyers gave their clients. For example, on public television the very day the 1981 tax reduction bill was signed, MacNeil and Lehrer interviewed tax accountants who explained how to take maximum advantage of the tax cut by postponing income and bringing deductions forward to the 1981 tax year. On August 25 Sylvia Porter's column began: "Millions of you, in corporations ranging from salespersons to physicians to lawyers can shift portions of your income from 1981 to 1982. Start arranging to do so now, and you will be able to cut your federal income taxes substantially." On October 26, 1981 Business Week wrote about the "flood of advice on postponing

income and accelerating deductions."

How were economists (and some Reagan policymakers) responding in 1981 to a recessionary monetary and fiscal policy? Almost universally they were predicting inflation. Among many, Walter Heller was convinced that the proposed tax cuts would inject too much inflationary purchasing power into the economy. He asked in the Wall Street Journal on February 10, 1981: "How can the economy absorb that big an expansionary punch without aggravating our already intolerable inflation?" A few days later Washington Post columnist Hobart Rowen, who stays tuned in to the Brookings Institution, declared that the tax cut was "so big that traditional Republicans and many Democrats regard it as dangerously inflationary." So did Mr. Rowen: "Even if Congress were to pass budget cuts that matched the tax cuts dollar for dollar, there is nothing in the fiscal program--in the view of those not addicted to supply-side theory--that works against inflation. The nation would still be face to face with OPEC, Reagan's oil deregulation orders, high farm prices, and escalating wages. And the Federal Reserve would be following a restrictive credit policy maintaining high interest rates, themselves a collateral cause of inflation."

Over the succeeding months the inflation hysteria grew. On May 11, Senate Finance Committee Chairman Bob Dole told the New York Times that he personally continued to fear that the tax cut would be inflationary. At a July meeting of the board of governors of the Federal Reserve System with its economic consultants, Alan Greenspan expected that a restrictive monetary policy would be overwhelmed by the tax cuts, and inflation would

explode. Monetary policy was "the junior partner," Greenspan said, and could "do nothing other than a weak rear-guard action." There can be little doubt that Volcker was encouraged to overreact by clamping down on money growth so that he would not be left holding the bag for an inflationary administration.

Almost every week during 1981 brought a new hand-wringing from Herbert Stein, who was certain that wild-eyed supply-siders were going to send the economy up in the smoke of inflation. So was the New York Times, which on July 29 editorialized again that "the Great Tax Cut of 1981 . . . promises more inflation."

An old-fashioned Keynesian belief in the predominance of fiscal policy had combined with a natural envy of the influence that a handful of supply-side economists had on national economic policy to whip up an inflation hysteria even while the economy was plummeting into recession. The inflation hysteria that was so assiduously cultivated by economists and the media was a principal cause of the recession. In such an atmosphere not even the Secretary of the Treasury could succeed in calling attention to the recessionary monetary policy. My additional argument that fiscal policy itself was recessionary had an even smaller audience.

Secretary Regan's warning in the first week of August 1981 that the Fed was leading the economy into recession had no effect. By October the situation was desperate. Regan again called for the Fed to honor its own targets and to loosen the extraordinarily tight monetary reins. Time quickly described the Treasury secretary as a "wanderer from the true faith," and

gleefully told how CEA Chairman Weidenbaum had called Regan and asked him, "What's going on here? We've got to be talking with one voice."[3]

What was going on was the economy was sinking into the black hole of recession, and the "one voice" was pretending that the problem was inflationary deficits caused by the tax cuts. Weidenbaum, Time reported, "was opposed to the Fed pumping more money into the economy now"--a strange point of view considering that the M1 numbers showed that the Fed had been pumping money out of the economy for the past six months and was far below its target. OMB Director David Stockman rushed off to a breakfast meeting with reporters the day after Regan's warning where, Time reported, he "contradicted Regan by arguing that the Fed should keep the brakes on the money supply."

Former Treasury Secretary William E. Simon has said that as soon as a President is elected he is captured by the past. Ronald Reagan was no exception. Ostensibly the President was bringing about a big change in economic policy. Change itself is unsettling even if people are convinced that it is needed. Even very positive changes disrupt many relationships, cause uncertainty and depreciate human capital. Big change can succeed only if the government shows confidence. But the President brought on board too many people who did not share his faith in his policies and who were not prepared to assume the risks of implementing them. As a result, internally the administration lacked confidence, and it was reflected publicly in many decisions, such as the one to delay the tax rate reductions in order to balance the budget. The Fed perceived this lack of

confidence and moved to take control over economic policy.

The dead hand of the past overwhelmed many of the hopeful changes that Reagan intended for the economy. From the beginning the emphasis was shifted from hope to gloom, and from economic growth to balancing the budget with austerity. Republican economists like Alan Greenspan, Herbert Stein, and Arthur Burns were very negative about the President's economic program. They believed that if nothing was done to stimulate the economy, inflation might be gradually squeezed out as long as the budget was balanced. Greenspan did not lack allies in the administration and the Senate Budget Committee.

Before the new administration was a month old we were engulfed in such a gloomy atmosphere that a dreary forecast was labeled a "rosy scenario." Despite the restructuring of the tax code envisioned to improve saving and investment incentives, the real GNP growth projections in the February 1981 forecast were lower than the economy achieved in 1976, 1977 and 1978. They were significantly lower than the original forecasts of the Carter and Ford administrations. Yet the hyperbole flew fast and loose. In an editorial on March 9, 1981, the Washington Post charged that President Reagan's "scenario lies far beyond the limits of any past experience in this country or any other industrial democracy."

The inflation outlook was also gloomy due to the influence that core inflation had on Weidenbaum and Greenspan. According to the DRI model at the time, core inflation was 10 percent, which meant that monetary policy could do little. The conflict

between the lower nominal GNP path based on the monetarists' assumptions about the growth rate of money and the higher inflation rate projections demanded by the core inflationists was resolved when David Stockman arbitrarily raised the nominal GNP path in order to project a balanced budget. This created the famous "velocity problem" (the projected GNP being too high for the projected money supply to support without a dramatic increase in velocity of circulation) and led to a chorus of criticism from Keynesian economists, who had never previously put any store in monetarist ruminations about velocity.

Had the traditional economists been blamed for insisting on core inflation and a balanced budget, much less damage would have been done to the credibility of the President's economic program. Instead the rumor was spread that the supply-siders were monkeying around with the numbers in order to project real growth and lower inflation, an impossibility according to the Phillips curve. The effect was to spread the insidious belief that the President's program was unrealistic and based on nothing but an extremist ideology. Some administration sources themselves fed this notion as part of their fight for power. All of these things undermined the confidence that is necessary for change to succeed and allowed the Fed to become the arbiter of economic policy.

The supply-side economists in the Treasury were prepared to accept deficits as the price of restructuring the tax code and bringing down inflation. We believed the deficits would be kept within reason by controlling the growth of government spending and that spending restraint and economic growth would eventually

balance the budget. We were opposed to making a balanced budget the issue or goal of the economic program. We knew that if a balanced budget became the issue, traditional Republican economists would shift the focus of policy to austerity, which would worsen the performance of the economy and enlarge the constituencies for federal spending programs. Even if we could succeed in holding on to the President's program internally, we knew that once a balanced budget was the goal, the President would be at the mercy of the Congress and the Fed. The former could destroy him by spending and the latter with tight money.

In retrospect the Treasury was right. Once Stockman succeeded in making the deficit the issue, the old Republican strategy of trying to fix the budget prior to fixing the economy prevailed. First the tax cuts were delayed in the name of a balanced budget--while the Fed closed down the economy with tight money. The recession produced deficits, and the Republicans responded by raising taxes in the middle of a recession, repealing some of the incentives for business investment contained in the 1981 tax reduction. This was followed up by more tax increases. Continued agitation for further tax increases has hovered over the Reagan presidency like a black cloud. Policymakers and economists were soon making more grandiose predictions about the economic benefits of raising taxes than Art Laffer and Jude Wanniski had made for lowering taxes.

On the monetary policy front, so far, "stop-go" has prevailed over the Reagan administration's request for moderate,

stable and predictable growth in the money supply. Successful investing continues to depend on skill at guessing the Fed's behavior.

One might say that it is more important that inflation is down than how it came down, a point that might have some merit. But the confused and unexpected--indeed, accidental--way in which inflation was brought down imposed substantial economic and political costs that have been shifted to President Reagan and the new fiscal policy. Moreover, the implications of these costs are not yet fully known. The large budget deficits may yet lead to incentive-destroying tax increases or to a weakened national defense. Policymakers might respond inappropriately to the dollar's sharp recovery from the historic low to which it was driven by a decade of rising inflation. The political costs of the sudden erosion in the asset values underlying farm debt, for example, are yet to come in. The world debt crisis is not yet over, and the implications of the enlarged role of the International Monetary Fund in the international financial system are not yet clearly visible.

Disagreement among economists, disunity in administrations, and political competition all work to enhance the Fed's discretionary power. The policy situation can be improved, and the Fed's integrity enhanced, with some small changes that will help to make the Fed more accountable. The Secretary of the Treasury could be reinstated as a member of the open market committee. That would allow the administration to have knowledge of what the Fed was doing, and it would provide occasions for the Fed to listen to what the administration was

saying. The terms of the members of the Fed's Board of Governors could be reduced from 14 to 7 years to increase turnover and the infusion of fresh ideas. It might also be helpful if some things were done to reduce the secrecy with which the Fed conducts its operations. For example, policy changes might be announced immediately.

None of these suggestions will provide a panacea. Conventional wisdom will always be flawed and this, together with the general political competition between parties, within parties, and among economists themselves will always create a fertile environment for the discretionary exercise of power. As long as governments are making policy, there will be inescapable dangers.

Footnotes

1. "The Economic and Budget Outlook: An Update," September 1982.

2. See Paul Craig Roberts, "Dawdling with Incentives," Wall Street Journal, August 7, 1980.

3. Time, October 19, 1982.

Response of Richard Rahn to Written Questions Posed by Senator Proxmire

Congress of the United States
JOINT ECONOMIC COMMITTEE
Washington, DC 20510

April 30, 1985

Dr. Richard Rahn
Chief Economist
United States Chamber of Commerce
1615 H Street, N.W.
Washington. D.C. 20062

Dear Dr. Rahn:

I was not able to attend the April 23, 1985, hearing before the Subcommittee on Monetary and Fiscal Policy during which you testified on the hearing topic of "Tax Reform, Tax Rates, and Tax Revenues." I do have some questions that I would appreciate your answering for the hearing record, including some specific questions on the tax issues raised during the hearing and some more general questions on supply-side economics. The questions are attached.

You may submit your responses either with your corrected hearing transcript or directly to Mr. Ed Jacobs at the Joint Economic Committee, G-01 Dirksen Senate Office Building, Washington, D.C. 20510. I would also appreciate having a copy of your responses for my own use.

Thank you for taking the extra time to answer my questions.

Sincerely,

William Proxmire
U.S.S.

WP:rkt

Attachments

QUESTIONS SUBMITTED BY SENATOR PROXMIRE

TO WITNESSES TESTIFYING APRIL 23, 1985, BEFORE THE

SUBCOMMITTEE ON MONETARY AND FISCAL POLICY

OF THE JOINT ECONOMIC COMMITTEE

1. Back in 1980, supply-siders predicted that the savings rate would climb from 6 percent of disposable income in 1980 to more than 8 percent by 1984. Instead, the savings rate dropped to a mere 4.9 percent in 1983 and has only recently returned to the 6 percent level.

   Critics would charge that this destroys your argument for the supposed incentive effects of higher after-tax returns on savings.

   How do you explain the lack of growth in the rate of personal savings?

2. Back in 1981, Treasury Secretary Donald Regan said that improvements in depreciation write-offs and an increased investment tax credit would result in a large increase in business investment from 11.5 percent of gross national product to 14.5 percent in 1984. However, business investment rose less than one percentage point over the period.

   Certainly, Treasury Secretary Regan and supply-siders did not count on a recession, but the upswing in business investment over the entire period was still somewhat below your expectations. Wouldn't you agree and how do you explain it?

3. Critics of the accelerated cost-recovery system, while acknowledgeing that it may stimulate investment to some degree, argue that it is stimulating the wrong kind of investment. Critics argue that investment in short-lived equipment is favored at the expense of longer lasting equipment and structures. Barry Bosworth points out that, despite the fast growth of gross investment, net investment, that is after adjustment for the wearing out and obsolescence of the capital stock, has climbed no higher as a percentage of GNP than it did in the 1975 recovery. In other words, it appears that compahies have been buying equipment that either quickly wears out or quickly becomes obsolete. How do you explain the fact that business appears to be investing more but total plant and equipment is growing no faster than it did in the 1970's? Doesn't this heavy investment in short-lived assets potentially undermine future U.S. competitiveness?

4. Donald W. Kiefer, the Congressional Research Service's tax policy analyst, concluded in a report that studying the published tax return data for 1982 neither proves nor disproves the supply-siders' claim that the Economic Recovery Act of 1981 induced upper income taxpayers to rely less heavily on tax shelters and to pay more, not less, income tax because the tax data do not enable separating out a number of important effects.

   I plan to place in the Record the introduction and summary of Mr. Kiefer's study, and I would appreciate your replying to it for the Record.

5. I am one of those who feels that there are substantial risks associated with the current situation of sky-high budget deficits, the high interest rates, and the dependence on continued import of capital.

   Clearly, capital imports in the past few years have served as an important safety valve that relieves the pressure of public-sector deficits on investment activity. But, I believe there are also limits to the volume of capital that can be imported, and there is some indication that the overly strong dollar position is weakening. I would like your comments on the implications of continued budget deficits, high value of the U.S. dollar in world markets, and the continued dependency of the United States on capital imports.

6. Many supply-siders seem to feel that economic growth will eventually shrink the budget deficit. What if this view is wrong and a serious recession does occur between now and the end of the decade? Wouldn't the present large structural budget deficit suffer another astronomical increase and what would be the consequences for monetary policy, fiscal policy, and the future of the American economy?

7. What evidence do you have that work effort has increased especially for high-income individuals?

8. What direct evidence do you have that tax avoidance and the use of tax shelters have declined?

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Washington, D.C. 20540

THE 1982 TAX RETURN DATA AND SUPPLY-SIDE RESPONSE: MANIFESTATION OR MIRAGE?

Donald W. Kiefer
Specialist in Public Finance
Economics Division
July 31, 1984

THE 1982 TAX RETURN DATA AND SUPPLY-SIDE RESPONSE TO THE TAX CUT: MANIFESTATION OR MIRAGE?

INTRODUCTION AND SUMMARY

Recently, a series of well-publicized claims has been made that preliminary data from the 1982 individual income tax returns verify the supply-side arguments regarding the expected effects of the tax cut included in the Economic Recovery Tax Act of 1981 (ERTA). The claims have pointed out that in 1982, the first year during which a portion of the tax cut was in effect for the full year, taxpayers in upper-income brackets paid a larger proportion of total income taxes than in 1981, and also paid more taxes in absolute terms than in 1981, despite the tax cut. These observations are claimed to show that the tax cut induced upper-income taxpayers to rely less heavily on tax shelters, and that the distribution of the tax cut was not unfair, as some have criticized, because the upper-income taxpayers are paying more tax, not less.

This paper examines these claims. Theoretically, it is correct that a reduction in marginal tax rates should induce less reliance on tax shelters and other tax-favored activities. The strength of this response to the ERTA tax cut is, however, open to question. It is also questionable whether the published tax data shed any light on this issue. The implications regarding the fairness or equity issue are more clear, but require concentration on the effects of the tax cut on the distribution of income, not simply on tax payments.

The principal points made in the analysis may be summarized as follows:

- The published tax return data are not well suited to studying the responses of taxpayers to tax policy changes because the data do not report a comprehensive income measure, and they do not permit observing the circumstances of individual taxpayers, or even the same group of taxpayers, from one year to the next.

- Higher total tax payments in an income bracket in 1982 than in 1981 occurred only in the $40,000 to $50,000 income bracket and in brackets above $150,000. Thus, the income level above which returns in all brackets paid higher taxes in 1982 than 1981 is $150,000; the brackets above this income contained only 0.3 percent of all tax returns in 1982.

- The higher total tax payments in the high-income brackets are attributable to the fact that in 1982 there were more returns in these brackets than in 1981. An increasing number of returns in upper-income brackets and a decreasing number in lower-income brackets is a natural consequence of the general growth in income. Furthermore, the tax return data provide evidence of substantial tax planning activities (acceleration of deductions to 1981 and deferral of income to 1982) at the highest income levels, which distort the 1981 and 1982 data. There is no way, using the tax return data, to identify separately the effects of these influences versus the supply-side effects. Thus, the published tax return data can be used neither to prove nor disprove the existence of significant supply-side responses to the tax cut.

- The tax planning activities apparent in the highest-income brackets make a comparison of 1981 and 1982 tax data misleading regarding both tax payments and the size of the tax cut. When the tax cut is measured as the change in effective tax rates from 1980, prior to any effects of the tax cut, to 1982, the magnitude of the tax cut is consistent with the projections made at the time of its passage. That is, contrary to some recent claims, the tax cut is largest in the highest-income brackets.

- The published tax return data are also not well suited to studying the distributional effects of tax policy, both because they do not report a comprehensive income measure and they do not report any information regarding people who do not file income tax returns. If the data are used for this purpose, however, they indicate both that the distribution of income was more unequal and that the income tax had a smaller effect in reducing inequality after the tax cut than before, which seems inconsistent with the claim that the tax cut increased the equity of the tax system. Taking into account the possible supply-side effects of the tax cut in the highest-income brackets makes the tax cut appear less

progressive, not more so. On the other hand, examining tax progressivity from this perspective focuses attention on the equity/efficiency trade-off involved in progressive taxation. If there are significant supply-side responses to higher marginal tax rates, then more progressive taxation and greater income equality are achieved at the cost of reduced aggregate income and output. The 1982 tax return data, however, do not shed much additional light on the nature of this trade-off.

CHAMBER OF COMMERCE
OF THE
UNITED STATES OF AMERICA

1985 MAY 23 AM 1:04

May 16, 1985

RICHARD W. RAHN
VICE PRESIDENT
CHIEF ECONOMIST

1615 H STREET, N.W.
WASHINGTON, D.C. 20062
(202) 463-5620/23

The Honorable William Proxmire
United States Senate
Washington, D. C. 20510

Dear Senator Proxmire:

Thank you for your letter of April 30, 1985. Attached is my response to the series of questions you had concerning tax reform, tax rates and tax revenues.

If you desire further information or if I can be of service to you in any way, please do not hesitate to contact me.

Sincerely,

Richard W. Rahn

RWR:pvs

Enclosures

Response of Richard Rahn to Written
Questions Posed by Senator Proxmire

1) Any assessment of the incentive effects of higher after-tax returns on savings must include not ony personal savings but business savings as well. Net national savings rose from $212.5 billion in 1981 to $416.9 billion in 1984. As a percentage of GNP, personal and business savings rose from 7.4% in 1981 to 11.7% in 1984, including the 1981-82 recessionary period.

2) I do not agree that the increase in business investment resulting from improvements in incentives was below expectations. Due to improvements in depreciation write-offs and the increased investment tax credit, investment during the 1981-82 recession was down less than in previous recessions and up more in the current recovery than in previous recovery periods (as a percentage of GNP). Taking an average of seven postwar recessions, five quarters after the peak of the recovery period, capital formation was down 14.2%. During the same period of the 1981-82 recession it was down only 7.5%.

Taking an average of seven previous recoveries, an eight-quarter percentage increase in fixed non-residential investment was 15.9% (5.7% of GNP). During the most recent recovery, the increase was 32.4% (12.5) of GNP).

3) Present law in present discount value terms is almost equal to expensing. Expensing is neutral across asset types.

The stimulation of investment by ACRS (or expensing) would increase U.S. competitiveness, not undermine it, by encouraging investment in state-of-the-art technologies and more frequent replacement of obsolete equipment, increasing productivity, efficiency, and wealth creation. Recent experience with lengthened depreciation systems showed that attempts to approximate "economic depreciation" discouraged new investment and encouraged businesses to hang on to technologically obsolete plant and equipment. Lengthening-out depreciation systems would undermine U.S. productivity and efficiency, reducing our competitiveness abroad.

4) I would support improved tax data collection, however, we must attempt to analyze the current data available. I believe that the Economic Recovery Act of 1981 did induce upper income taxpayers to rely less heavily on tax shelters and to pay more in income tax.

The very existence of an increased level of tax returns indicates that the tax rate reductions were successful. More returns are filed because the reductions have encouraged higher income taxpayers to shelter less income and declare more, increasing their tax payments. This is the essence of supply-side economics, that tax rate reductions will increase revenues to the government.

Including the results of the third year tax cut, the income level above which revenues collected increased is $50,000, down from the $100,000 level in 1982. Although their tax rates were reduced from 70% to 50%, those earning over $1 million paid 37% more taxes in 1982, a recession year, than 1981. Those earning between $500,000 and $1 million annually paid 25% more taxes in 1982 than 1981. By 1983, those earning over $1 million were paying 102% more in taxes. Those earning between $500 thousand and $1 million paid 47% more.

The ERTA tax rate reductions resulted in a more progressive tax system. Between 1981 and 1983, the tax burden of those earning over $1 million

increased from 1.7% to 3.6% of the total tax burden. The tax burden of those earning between $500,000 and $1 million increased from 1.6% to 2.4%. The tax burden fell (as a percentage of the total tax burden) for all income catagories below $50,000.

5) Spending cuts by Congress are the solution to the budget deficit problem. Spending cuts will relieve pressure on capital markets, reducing interest rates. As interest rates fell, foreign capital imports will lessen as investment in the U.S. becomes less attractive. Less capital imports will reduce pressure on the dollar, lowering its value in world markets. Lower interest rates will be available for business expansion without competition from government borrowing, increasing economic growth.

6) Spending cuts will shrink the budget deficit and contribute to economic growth, therefore, spending cuts are pro-growth. A continuous budget deficit is a drag on the economy (partially because of government competition in capital markets) and will eventually cause a recession, unless the government inflates the money supply to relieve the pressure; however, this is inflationary.

7) None at this time.

8) None at this time.

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